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S. Guhan

MADRAS INSTITUTF OF DEVELOPMENT STUDIES
79, SECOND MAIN ROAD, GANDHINAGAR, ADYAR
MADRAS 600 020

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79, Second Main Road, Gandhinagar,

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Introduction

The eighth in the series of Finance Commissions under the Constitution of India has been set up in June 1982 under the Chairmanship of Shri Y.B.Chavan. The Commission has been requested to make its report by 31 October 1983 and its recommendations are to cover the period of 5 years commencing from 1 April 1984 i.e., 1984-1989.

The usual procedure followed by Finance Commissions is to invite memoranda on their terms of reference from State governments along with a detailed projection of the State's financial picture in the award period (e.g. 1984-1989 in the case of the VIII Commission). The Commission then visits State capitals for discussions with each State government. The memoranda submitted by the States and the Commission's discussions with them are not open to the public. However, at its headquarters in Delhi and during its visits to the States, the Commission invites academics, legislators, industrialists and other interested persons and groups to provide oral or written testimony on the issues covered in its terms of reference. The setting up of a Finance Commission generally stimulates academic articles and seminars on the problems of federal finance in India. At the next stage, the report of Finance Commissions contain useful data on State finances and allied matters and a discussion of general issues of Centre-State financial relations. Following the report, there is a further crop of comments and criticisms on what the Commission was able or unable to do in response not only to its specific terms of reference but also to a wide gamut of outstanding problems in Indian federal finance. Thus interest in the Commission's work gets generated at different stages -- during

the deliberative stage of the Commission's sittings, in examining its report, and in reacting to criticisms of the report. In this context, this paper attempts to provide a background that might be useful for an understanding of the issues involved in the work of the Finance Commissions. We begin with a section that introduces the arrangements for financial sharing in the Indian federation and defines the further scope of the paper.

I

Sharing and transfers, vertical and horizontal

The constituents of our federation are the Union (or the Centre) and the States of whom there are 22 in India at present.[1/] The sharing of overall national financial resources within the constituents has 'vertical' and 'horizontal' aspects. These relate respectively to the sharing of resources between the Centre and the aggregate of States (vertical) and the sharing of the aggregate transfer from the Centre inter-se among the States (horizontal). These are not necessarily two sequential stages but rather inter-related components of a process. Both the principles and quantum of vertical sharing and the principles of horizontal distribution have an obvious bearing on the extent to which each State will benefit. The Constitution of India contains a scheme for vertical sharing. It also recognises the need for resource transfers from the Centre to the States or for vertical transfers. But the Constitution itself does not specify the extent of principles

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1/ In addition, there are 9 Union Territories directly administered by the Centre which can be treated, for our purposes, as part of the Centre. 'Union' is used in the terminology of the Constitution. We shall use 'Union' and 'Centre' synonymously.

that should determine the transfers either from the Centre to the States, or among the latter. These functions have been assigned in the Constitution to quinquennial Finance Commissions and, subsequently, in practice and in part to the Planning Commission. Transfers - vertical and horizontal - are thus mediated by both these Commissions.

Article 246 of the Constitution demarcates the spheres of responsibilities of the Centre and the States in terms of their legislative jurisdictions as laid down in the Seventh Schedule to the Constitution cited in this Article. The major responsibilities of the Centre include defence, external relations and communications. The States have responsibility for law and order and for other basic administrative services. In the framework of the National and State Plans, both have large developmental responsibilities with the brunt of the outlays on power, irrigation, agriculture, and social services such as education and health falling in the State sector. As part of their respective legislative powers, the tax jurisdictions of the Centre and the States are contained in the Seventh Schedule.1/ The main tax sources for the Centre are taxes on private and corporate incomes, excise duties and custom duties. The main sources available to the States are sales taxes, excise on liquor, motor vehicle taxes, entertainment taxes, stamp duties and land revenue. These sources, which form the taxable base for the Centre and the States, provide the initial framework for vertical sharing.

The Constitution also recognises the possibility that at an aggregate level the States might have a need for resource transfers from the Centre arising from an imbalance between

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1/ Entries in the Seventh Schedule relating to taxation are reproduced in Annexure I.

the expenditure burdens for which they have responsibility, or which might be placed on them, and the revenue potential that they may be in a position to exploit. It provides for such transfers in the following ways.[1/] Firstly, under Article 268 certain taxes (viz., stamp duties and excise on medicinal and toilet preparations) which are levied by the Centre are collected and appropriated by the States within which they are leviable. Article 269 lists a set of seven taxes which may be levied and collected by the Centre but which will have to be wholly assigned to the States within which they are levied. Thirdly, under Articles 270 and 272, the Constitution expects or permits the Centre to share a part of its revenues from income taxes and Union excise duties with the States. Fourthly, Articles 275 and 282 make it possible for the Centre to give grants-in-aid to the States. Of these modalities of vertical transfers provided for in the Constitution, the first two are of relatively minor importance. It is tax-sharing under Articles 270 and 272 and the grants under Articles 275 and 282 that are of significance. In addition, loans from the Centre to the States form an important avenue of resource support and this is enabled under Article 293.

The extent of the "imbalance" we referred to and the magnitude of the transfers required to correct it could be illustrated from the Central and State budgets for 1981-82. In that year, out of a total estimated initial accrual of tax revenues for the Centre and the States taken together of Rs.22,182 crores only Rs.7514 crores or 33.9 per cent was to the account of the States. On the other hand, the share of the States in the total estimated revenue expenditure for the Centre and States together (viz., Rs.28,069 crores) came to 55.4 per cent. This imbalance was substantially corrected with the transfer of Rs.4131 crores from the Centre

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1/ See Annexure II for an extract of the Constitutional provisions.

to the States amounting to 28.2 per cent of initial tax accruals to the Centre. The transfer, along with their non-tax revenues, brought up the States' share to 54.1 per cent of overall revenues available to the Centre and the States.

Inter-State variations

It is important to notice that such an aggregate imbalance in disfavour of the States vis-a-vis the Centre can mask wide variations as between individual States. In fact they do, as we shall show later. This is so for a variety of reasons. Expenditure burdens of States are a function of such factors as the size of the population, levels of poverty, extent of urbanisation, the proportion of the disadvantaged such as scheduled castes and tribes, and the levels of attainment to be made up in terms of literacy, health etc. These burdens can be discharged with greater or lesser cost-effectiveness, depending on the economy and efficiency of financial management. Salary levels, for instance are one important dimension, and determine the amount of financial resources needed to support a given physical quantum of activity such as schools or health care per unit of population. While the legal base for taxation is the same for all States, the 'tax potential' or 'taxable capacity' is a function of such factors as per capita incomes, income distribution, levels and composition of production and of consumption, and so on. The extent to which the potential has been exploited or the 'tax effort' also varies among States.

Taxes form the main but not the only source of revenue. Two other avenues of resource mobilisation are (a) non-tax revenues such as dividends, interest receipts, retained surpluses of public enterprises (reflecting investment levels and financial management) and revenues from natural resources such as mineral resources and forests (reflecting endowment

advantages) and (b) capital receipts from borrowings of various types and loan recoveries. Given the interplay of these various factors, the imbalance between receipts and expenditures can vary widely as between different States with such variations being a function of a variety of factors, some within and some outside the control of the States. A simplistic approach to the fiscal 'needs' of States can therefore be misleading.

The Centre's needs

The Centre's needs are of a different character than that of the States. They are not relatable to such parameters as population which are relevant in the case of the States. There are special problems in evaluating one of its principal needs which is defence expenditure. Yet in a federation, vertical justice requires that the Centre's financial performance and needs should also be subject to an objective assessment in terms of its resource mobilisation effort, its expenditure burdens, and the economy and efficiency with which they are undertaken.

The Finance Commission and the Planning Commission

The broad division of responsibility that has been arrived at in practice between Finance Commissions and the Planning Commission is that the former deals with transfers required to cover the non-Plan resource gaps of the States while the latter addresses itself to the transfers required for Plan expenditures. In recommending its scheme of transfers, the Finance Commission basically follows a three step process: (a) It makes its own independent assessment of State's 'non-Plan' receipts and expenditures and of the consequent 'non-Plan' resource gap. (b) It formulates certain general principles for tax-sharing. (c) It then recommends a volume of tax-sharing in terms of proportions in income-taxes and in Union excise duties

(i.e. the vertical component) such that with the superimposition of the principles of inter-se sharing among the States (i.e. the horizontal component), the needs of States will, by and large, get covered. To the extent that some of the States are still left with uncovered gaps it recommends statutory transfers to make up the balance. The awards of the Finance Commission are to cover the entire 5 year period included in their terms of reference. The recommendations of the Finance Commission are made available prior to the commencement of the Plan that extends over the period of their award.[1/]

The Planning Commission works within the framework of the Five Year Plan which defines the size of State Plans and the resources expected to be available at their level <u>including</u> the transfers made on the basis of the Finance Commission's recommendations. The financing pattern of the Five Year Plans indicate the total quantum of Central Plan assistance to the States during the Plan period. The basic formula for the distribution of this total quantum among the States is adopted by the National Development Council. The Planning Commission while applying this formula makes certain other adjustments to meet the special needs and problems of individual States. Within the 5-year framework of the Plan, annual adjustments in regard to the quantum of aggregate Central Plan assistance are also made having regard to the Centre's budgetary position.

Our enquiry will be concerned with how the Finance Commissions and the Planning Commission have individually and jointly approached the transfer issue; the validity, consistency and effects of the criteria employed by them;

1/ Award periods have not however necessarily coincided with Plan periods - vide Table 3 below and the connected discussion.

whether these are best calculated to promote redistribution and fiscal responsibility in the Indian context; and if not, whether more suitable alternative procedures could be considered. In what follows, section II is by way of a background. It summarises the constitutional provisions relating to the Finance Commission and the relationship that has evolved between the Finance Commission and the Planning Commission. Section III examines in detail the procedures adopted by both bodies, the transfer criteria developed by them, and the effects of such criteria with particular reference to the VII Finance Commission (1979-84) and the Sixth Five Year Plan (1980-85). Section IV suggests an alternative in the light of a critique of the procedures earlier reviewed. Section V concludes with a statement of certain outstanding issues in Centre-State financial relations which have remained unresolved despite successive Finance Commissions and the Planning Commission.

II

The principal constitutional provisions that have a bearing on the work of the Finance Commission are reproduced in Annexure II. The reference to the Finance Commission is in Article 280. It states that Finance Commissions have to be set up within two years from the commencement of the Constitution and thereafter at the expiration of every fifth year or at such earlier time as considered necessary. The Finance Commission shall consist of a Chairman and four other members.[1/] The Finance Commission shall make recommendations to the President (i.e. to the Government of India or the Centre) on (a) the distribution between the Union and the States of the net proceeds of taxes which are to be, or may be, divided between them and the allocation between the States of the respective shares of such proceeds and (b) the principles which should govern grants-in-aid from the Centre to the States. The Centre can also refer any other matter "in the interests of sound finance" to the Commission. The Commission is required to make recommendations on them but it is not expected suo motu to tackle such issues. Under Article 281, the recommendations of the Finance Commission have to be placed before Parliament with an explanatory memorandum on the action taken. The Constitution does not make it obligatory for the Centre to accept their recommendations although in ordinary usage the advice of the Finance Commission has come to be referred to as its 'award'.[2/]

1/ Annexure III contains a note on the composition of Finance Commissions.

2/ One important instance when the Centre did not accept a recommendation of the Finance Commission was in respect of the majority view of the III Commission (1962-66) that Article 275 grants should be provided to cover 75 per cent of the States' revenue expenditures on the Third Plan.

The taxes which are to be, or may be, divided between the Centre and the States are specified under Articles 270 and 272. They are (a) taxes on income, other than agricultural income[1/] and (b) basic duties of Union excise. Both these are levied and collected by the Centre. Of these, income taxes are to be shared with the States ("shall be shared" in the language of Article 270). The Constitution does not however specify a floor for the percentage to be shared under Article 270 or a ceiling on the percentage that may be shared under Article 272. There is thus considerable latitude as well as vagueness. In addition to sharing of these taxes, the Constitution provides for grants-in-aid to be made by the Centre to any State "in need of assistance" under Article 275. Such 'need' is left undefined. These statutory grants, as they are called, can however be made only on the advice of the Finance Commission.

The main purview of the Finance Commission therefore consists of the two taxes referred to in Article 270 and 272 and the grants-in-aid referred to under Article 275. Certain other issues are also conventionally referred to the Finance Commission for advice under the provision that permits the Centre to refer any other matter to it "in the interests of sound finance". A reference to paragraph 6 of the terms of reference for the VIII Finance Commission (Annexure IV) will show that the Commission has been requested to recommend changes, if any, to be made in the principles for the distribution among the States of (a) estate duty in respect of property other than agricultural land (an item under Article 269) (b) additional excise duties on certain

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1/ Corporate taxes are excluded from "taxes on income" for the purposes of Article 270. This change was brought about in 1959. Under Article 271, the Union can levy surcharges on incometax which it need not share with the States.

commodities in replacement of sales taxes (c) the grant in lieu of the tax under the repealed Railway Passenger Fares Act 1957 and (d) the grant on account of wealth tax on agricultural property. Of these, items (a), (c) and (d) add up to quite an insignificant proportion, generally about one per cent, of total transfers; and, the background to the sharing of these minor revenues does not deserve to detain us. The additional excise duties in lieu of sales taxes are a more significant item. The background to this is that subsequent to the Constitution, the States voluntarily agreed to allow the Centre to levy additional excise duties in lieu of sales taxes on cotton fabrics, woollen fabrics, rayon or artificial silk fabrics, sugar, and tobacco, including manufactured tobacco. This was based on the understanding that the proceeds will be wholly distributed back to the States according to some appropriate formula that will correspond as closely as possible to the revenues that each of them would have derived if they had continued with the sales taxes. In principle, this represents a tax-rental arrangement between the States and the Centre which does not attract the kind of redistributive principles involved in the sharing of income-taxes and basic excise duties. Essentially, the position with respect to items (a), (c) and (d) is similar. All these items, although they may form part of the Finance Commission's recommendations, are analogous to State's own taxes in their character.

It will be useful to have an idea of the relative importance of different sources of transfer. Table 1 shows the estimated transfers under various heads under the recommendations of the VII Finance Commission (1979-84). Income taxes account for 22.9 per cent, basic excise duties for 54.3 per cent, and statutory grants for 7.7 per cent. These three which are under Articles 270, 272 and 275 form the primary sources, accounting for 84.9 per cent of the total. Of the total amount of tax-sharing

Table 1

Analysis of transfers under VII Finance Commission

	Source	Amount (Rs. crores)	per cent to total
1.	Income taxes	4,791.39	22.9
2.	Basic excise duties	11,347.46	54.3
		16,138.85	77.2
3.	Additional excise duties in lieu of sales taxes	1,867.07	8.9
4.	Excise on power	1,145.88	5.5
5.	Grant in lieu of Railway Passenger Fares Tax	81.25	0.4
6.	Estate duty	64.00	0.3
7.	Statutory grants under Act 275	1,609.92	7.7
	Total	20,906.97	100.0

Source: Report of the Seventh Finance Commission, 1978 p.157.

from the two main taxes, excise duties have provided the major source amounting to 70.3 per cent with the balance of 29.7 per cent coming from income taxes. The additional excise duties and the excise duty on power (which was levied by the Centre in 1978 and later made over to the States) come to 14.4 per cent. Both these latter are of a tax-rental nature. The grant in lieu of the Railway Passenger Tax, and the estate duty on property other than agricultural land are, as pointed out earlier, quite minor items adding up together to 0.7 per cent of the total estimated transfers.

Two important issues on which it has become customary to invite the Finance Commission's advice since the VI Commission (1974-79) are (a) in regard to an assessment of the States' non-Plan capital gap (vide paragraph 9 of Annexure IV) and (b) the financing of relief expenditures incurred by States on account of natural calamities such as droughts and floods (vide paragraph 10 of Annexure IV). The non-Plan capital gap of the States arises to a very substantial extent from their debt repayment liabilities to the Centre. The VI and VII Finance Commissions have been able to provide relief to the States through the consolidation, partial write-off and extension of these payments. On the second item, they have been able to suggest appropriate formulae for taking care of additional expenditures cast on the States by natural calamities.

One issue on which the advice of the VII Finance Commission has been sought is an innovation. The current Commission has been requested to "examine the scope for raising revenue from the taxes and duties mentioned in Article 269 of the Constitution but not levied at present and the scope for enhancing revenue from duties mentioned in Article 268" (vide paragraph 8 of Annexure IV) A reference to these two articles will show that what is

implied here are possible increases to stamp duties and excise duties on medicinal and toilet preparations (Article 268) and possible taxes in regard to items (c) to (f) in Article 269(1) which are not being levied at present. The yield potential from these sources is not likely to be significant but it is a welcome and interesting innovation that the Finance Commission has been requested to advise on measures for additional tax mobilisation.

We may complete our introduction to the terms of reference of the VIII Commission by referring to the two other substantive paragraphs of Annexure IV. Paragraph 5 is in the nature of guidelines to the Commission and relate to the procedures to be adopted by them in assessing the requirements of States.[1] Paragraph 7 requires the Commission to adopt the population figures of 1971 wherever population is to be used as a criterion for determining shares in taxes or for working out grants-in-aid. Whatever be the reason behind this, whether the practical problem of not having the State totals for Assam or a desire to stress family planning, the effect will be to prejudice the States which have had relatively higher growth rates since 1971; and these are some of the poorest States in India.

1/ I.S.Gulati (1979) p.16 et seq has argued that such guidelines amount to an erosion of the independence of the Commissions but a more relaxed position is taken in I.S.Gulati (1973) p.1296. In our view, the guidelines only codify practices and procedures as they have evolved. They do not appear to be objectionable in substance and, in any event, they do not bind the Finance Commission.

Relationship to the Planning Commission

When the Constitution was framed, the entire process of transfer was envisaged as taking place under the institutional intermediation of the Finance Commission and subject to the provisions of Articles 269, 270, 272 and 275. The planning process had not been initiated and the Planning Commission had not been thought of at that time. With the entry of the Planning Commission in the picture the position changed. The Planning Commission began to be used as the institution for advising the Centre on Plan assistance to the States comprising both grants and loans. The role of the Finance Commission began to be directed more specifically towards meeting needs of States on the non-Plan account. This is a division of labour arrived at in practice. It does not amount to any limitation on the powers of the Finance Commission under the Constitution which do not restrict the end-uses to which the transfers recommended by the Finance Commission could be applied. They could be used for Plan or non-Plan purposes and for covering revenue or capital expenditures. In fact, up to the stage of the IV Finance Commission (1966-69) some ambiguity was maintained and the Finance Commission was also seen as having a role in recommending transfers towards Plan expenditures. It was the IV Finance Commission, under the Chairmanship of Justice P.V.Rajamannar, that crystallised the position in the following terms.

"When the provisions regarding the Union-State financial relations were incorporated into the Constitution, it was not possible for any one to anticipate the importance and magnitude of our successive Five Year Plans. There was no reference to Plan expenditure as such in the terms of reference of the First Finance Commission (November 1951 - December 1952) and that body did not find it necessary to draw a line of distinction between Plan and non-Plan expenditure. In fact, it emphasised the need for taking into account development expenditure of

various types in determining the transfer of resources from the Centre to the States. The Second Finance Commission (June 1956 - September 1957) was, however, specifically asked to take into account both the requirements of the Second Five Year Plan and the efforts made by States to raise additional resources... The Third Finance Commission (December 1960 - December 1961) recommended grants under article 275 to cover 75 per cent of the States revenue expenditure on the Third Plan but the Government of India did not accept this recommendation.

> The terms of reference of the Fourth Finance Commission do not expressly mention Plan expenditure.... The Constitution does not make any distinction between Plan and non-Plan expenditures and it is not unconstitutional for the Finance Commission to go into the whole question of the total revenue expenditure of the States..... It is, however, necessary to note that the importance of planned economic development is so great and its implementation so essential that there should not be any division of responsibility in regard to any element of Plan expenditure. The Planning Commission has been specially constituted for advising the Government of India and the State Governments in this regard. It would not be appropriate for the Finance Commission to take upon itself the task of dealing with the States' new plan expenditure."1/

The fact that the Finance Commission directs its transfers to meeting the non-Plan gap does not mean that it has to limit its transfers to the non-Plan gap. It can go beyond it and provide surpluses on the non-Plan side which at the subsequent stage will be available for meeting Plan expenditures. These can be taken into account in determining the transfers under the aegis of the Planning Commission. This view was explicitly adopted by the VII Finance Commission which substantially increased the quantum of vertical transfers, and as a justification for doing so, in the following words:

1/ Report of the Finance Commission (1965) pp. 8-9.

> "In our view the role of the Finance Commission should not be negative, of filling in the revenue gaps only, but positive in that its scheme of devolution gives a better start for developmental outlay."

It is important to notice also that the non-Plan/Plan distinction is not the same as a distinction between non-development and development expenditures. In the States' sector, a substantial element - about 70 per cent in the aggregate - of non-Plan expenditures are related to developmental purposes, particularly to the continuation of services and facilities created under previous Plans. In making transfers to meet the non-Plan gap, the Finance Commission accordingly makes a substantial contribution to the financing of developmental outlays.

Table 2 shows the volume of transfers that have been made since the beginning of the First Plan (a) by way of tax-sharing and statutory grants recommended by the Finance Commission (b) as Plan transfers and (c) as non-Plan transfers which principally include the financing of relief expenditures, States' share in small savings collections and advances to clear overdrafts. It will show that the Finance Commission transfers have increased from about 30 per cent of total transfers in the early 1950s to over 40 per cent in recent years. While currently annual Plan transfers are 27 times of their level during the First Plan, Finance Commission transfers are 57 times what they were in that period. The transfers recommended by the Finance Commission currently constitute over 65 per cent of the transfers that States receive by way of grants or shared taxes from the Centre. The Finance Commission has thus continued to be an important vehicle for the transfer of resources. It has not in any sense been side-tracked by the Planning Commission, of which it sometimes tends to be characterised as a high-born but poor partner. Its transfers form as important a proportion of total transfers as those of the Planning Commission; over

Table 2

Sources of Centre-State Transfers 1951-1983

(Rs. crores)

Period	Finance Commission	Plan	Non-Plan	Total
I Plan (1951-56)	447 (31.2)	880 (61.5)	104 (7.3)	1431 (100.0)
II Plan (1956-61)	918 (32.0)	1058 (36.9)	892 (31.1)	2868 (100.0)
III Plan (1961-66)	1590 (28.4)	2738 (48.9)	1272 (22.7)	5600 (100.0)
Annual Plans (1966-69)	1782 (33.3)	1917 (35.9)	1648 (30.8)	5347 (100.0)
IV Plan (1969-74)	5421 (35.9)	4731 (31.3)	4949 (32.8)	15101 (100.0)
V Plan (1974-79)	11168 (44.2)	10353 (41.0)	3761 (14.8)	25282 (100.0)
1979-1983	17372 (43.4)	15773 (39.3)	6928 (17.3)	40073 (100.0)
	38698 (40.4)	37450 (39.1)	19554 (20.5)	95702 (100.0)

Figures in brackets are percentages to the total in the last column.

Source: Compiled from Appendix IV.1(i) to (iv) of the Report of the Seventh Finance Commission (pp.172-178) and the Reserve Bank of India's surveys of the finances of the Government of India and of the States for 1979-1982. Figures for 1979-80 are actuals; for 1980-81 and 1981-82 are revised estimates; and for 1982-83 are budget estimates.

the years, their importance has tended to increase; the Finance Commission provides a substantial part of grants to States; it finances a substantial part of States' development expenditures; and, since its awards are antecedent to Plan transfers, they can create surpluses for Plan financing.

The Planning Commission has no constitutional status in the sense that, unlike the Finance Commission, it does not have a parentage in the original Constitution or in any subsequent amendment of it. It is purely an advisory body to the Centre. A Constitutional sanction is however necessary for the Centre to make Plan grants to the States otherwise than through the Finance Commission and for this purpose use has been made of Article 282 which permits the Union "to make any grants for any public purpose notwithstanding that the purpose is not one with respect to which Parliament may make laws." It has been argued that this Article which is one of the "miscellaneous financial provisions" in the Constitution has been over-extended in making substantial and recurring Plan grants to the States. Moreover it has been pointed out, including by Justice Rajamannar, that grants under Article 282 should be related to specific public purposes and can not take the form of general purpose Plan grants. These arguments are legalistic and could be resolved by appropriate constitutional amendments. In themselves, they do not undermine the validity of Plan transfers being made on the advice of the Planning Commission as part of the overall Planning process.

It has sometimes been argued that the Finance Commission, being an independent body created under the Constitution, should be given the authority to recommend Plan transfers as well and that Plan transfers made on the advice of the Planning Commission are 'discretionary' and do not have the status attached to awards of the Finance Commissions.

Two strong counter arguments to question this view are: (a) Plan transfers need to be made within the framework of the Five Year Plan and subject to annual budgetary exigencies reflected in the Annual Plans. A quinquennial body set up under Article 280 for the specific purposes contemplated under that provision can not discharge this function and (b) while there is an element of discretion in the transfers made by the Planning Commission, the bulk of them are governed by criteria adopted in advance by the National Development Council.[1/]

It will be clear that in as much as the Finance Commission and the Planning Commission have to look at two inter-related segments of the resource needs of States' their work needs to be organised within the same time-frame. Unfortunately, this has not always happened. Table 3 gives the award periods of successive Finance Commissions and the corresponding or overlapping Plan periods. Award periods and Plan periods have coincided only during the IV and V Commissions. In fact, while the award period of the IV Commission was originally to extend for 1966-71, its award was terminated at the end of 1968-69 after the three Annual Plans and the V Commission was appointed so as to cover 1969-74, the period of the IV Plan. However, a disruption took place during the award period of the VI Commission (1974-79) since the Janata Government terminated the Fifth Plan and embarked on a Rolling Plan with the first such being for 1978-83. Meanwhile, the VII Commission was appointed to cover 1979-84 and later, the Rolling Plan itself was replaced by the VI Plan for 1980-85 by the present Government. As a result, the VII Commission's award will terminate a year ahead of the conclusion of the VI Plan and the award period of the VIII Commission (1984-89) will in turn terminate a year

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1/ A reference to Annexure III on the composition of Finance Commissions will show that their 'independence' can not be taken to be self-evident. Despite its 'status', the Finance Commission is also no more than advisory.

ahead of the end of the VII Plan. At another level, however, an attempt has been made to coordinate the workings of the two bodies by including one member of the Planning Commission (so far one of its economist members) as a member of the Finance Commission. This arrangement, introduced for the first time in the VI Commission (1974-79), has continued in subsequent Finance Commissions.

Table 3 : Award and Plan periods

	Award Period	Plan period
I Finance Commission	1952-57	1951-56
II Finance Commission	1957-62	1956-61
III Finance Commission	1962-66	1961-66
IV Finance Commission	1966-69	1966-67 1967-68 1968-69
V Finance Commission	1969-74	1969-74
VI Finance Commission	1974-79	1974-78 1978-83
VII Finance Commission	1979-84	1978-83 1980-85
VIII Finance Commission	1984-89	1980-85 1985-90

We shall therefore take it as our starting point that both Commissions have come to stay and have important and inter-relating functions to discharge. The interesting issues relate to how these roles have been met individually; and whether jointly, the operations of both have cohered into an optimal policy for promoting developmental objectives. We shall examine these issues in the subsequent sections.

III

We now turn to the procedures adopted by Finance Commissions for assessing the needs of States on the non-Plan account and follow it up with an examination of the approach they have followed in the evolution of criteria for inter-se distribution of transfers among States.

Non-Plan revenue gap

Table 4 provides an integrated picture of the pattern of non-Plan and Plan financing.

The non-Plan gap for the States consists of two components: (a) the non-Plan gap on the revenue account and (b) the non-Plan capital gap.[1/] The non-Plan revenue gap (NPG(R)) is equal to the difference between tax revenues (TR) and non-tax revenues (NTR) on the one hand, and the sum of non-development expenditures (ND) and non-Plan development expenditures (NPD) on the revenue side on the other. I.e., NPG(R) = TR+NTR - ND(R) - NPD(R). Each of these components requires some annotation. We shall assume for the sake of simplicity that the prospective award period of the Finance Commission is the same as the prospective Five Year Plan period.

(i) The Finance Commission in projecting TR and NTR does so at the rates of taxation and tariffs attained at the end of the last year of the award period previous to its own.

1/ The revenue account in the budget reflects current expenditures on items such as salaries, allowances, pensions, subsidies, interest payments and so on. The capital account relates to direct investments (e.g. on roads, buildings, irrigation works), share capital investments (e.g. in industrial undertakings) and, in a broad sense, includes loans (e.g. to finance power projects).

Table 4 : Integrated picture of Non-Plan and Plan financing for States

(1)	State's revenues on non-Plan account	(1a) + (1b)
	(1a) Tax revenues (at pre-award rates)	
	(1b) Non-tax revenues (at pre-award charges, tariffs, prices)	
(2)	State's non-Plan revenue expenditures	(2a) + (2b)
	(2a) Non-development expenditures	
	(2b) Non-Plan development expenditures	
(3)	Finance Commission's provisions for upgradation of emoluments and for maintenance	-------------
(4)	Non-Plan revenue gap	(1)-(2) - (3)
(5)	Finance Commission's transfers on revenue account	(5a)+5(b)+(5c)
	(5a) Shares in taxes	
	(5b) Statutory grants, if any	
	(5c) Other transfers from additional excise duties, etc.	----------------
(6)	Non-Plan surplus or nil balance	(5) - (4)
(7)	State's additional resource mobilisation for the Plan	(7a) + 7(b)
	(7a) Through taxation	
	(7b) Through increases in tariffs etc	
(8)	Plan grants (i.e., Plan transfers on revenue account)	----------------
(9)	Resources available for Plan revenue component	(6)+(7)+(8)
(10)	State's capital receipts (non-Plan)	(10a)+(10b)
	(10a) Loan recoveries	
	(10b) Others through market borrowings, institutional loans, provident funds, small savings, non-Plan loans etc.	

(11) Repayments on Central loans	(11a) - (11b)
(11a) Repayments due	
(11b) Debt relief provided by Finance Commission	
(12) Other capital outgos (non-Plan)	
	---------------
(13) Non-Plan capital gap	(10)-(11) - (12)
(14) Plan loans	
	----------------
(15) Resources available for total Plan outlay	(9) + (14) - (13)

E.g., the VII Commission (1979-84) took into account rates as of 1978-79. The reason for this is that additional yields from taxes and tariffs accruing from rate increases or new impositions are counted as a Plan resource. In other words, in determining its transfers for the prospective award period, the Finance Commission enables such additional resources to be available for (additional) Plan expenditures. At the same time, there is an obligation on the part of the States to maintain the level of revenues projected on the basis of rates and tariffs in the pre-award period. If these were to get eroded, the State's own resources for the Plan will get correspondingly reduced. At the operational level, it is the Planning Commission that has to ensure that (a) the revenues of States are adequate to maintain the levels postulated by the Finance Commission and (b) additional resources, over and above such levels, are mobilised to the extent set in the Plan financing pattern for the State.

(ii) In regard to ND(R), all non-developmental revenue expenditures (such as on police, general administration, jails and so on) in the award period are taken into account. Interest payments on debt, including debt likely to be contracted in the award period, is an important element of ND(R).

(iii) NPD(R) is mainly the revenue expenditure on the maintenance or continuation of services and facilities created under previous Plans, including the one immediately antecedent to the award period.

While the NPG(R) is established in this way, correspondingly the Plan revenue gap consists of the difference between Plan revenue expenditures (i.e., outlays included in the Plan on the revenue account) on the one hand and the sum of additional resources that the States might raise during the Plan period and the surpluses on revenue account that they might have on the basis of the transfers recommended by the Finance Commission. It is this gap that is met by Plan transfers in the form of grants.

Non-Plan capital gap

On the non-Plan capital side, the main receipts are recoveries of loans made by State Governments. The main outgo is repayments on account of loans received from the Centre. Net borrowings from open market loans, Plan loans from the Centre, borrowings from institutions such as the LIC, net accretions to State Provident Funds, and small savings collections are all treated as capital receipts on the Plan side. In the projections made by the VII Finance Commission for 1979-84, for instance, estimated loan recoveries amounted to Rs.1457 crores for all States out of total non-Plan capital receipts of Rs.1465 crores. Out of total non-Plan capital outgos of Rs.4978 crores, loan repayments to the Centre amounted to Rs.4322 crores. It is, as we saw earlier, one of the terms of reference to the Finance Commission to make an assessment of the non-Plan capital gap during the award period, to undertake a general review of the States' debt position with reference to the Central loans advanced to them, and "to suggest appropriate measures to deal with the non-Plan capital gap". Similar terms of reference were also included for the VI and the VII Finance

Commissions. The intention has been to invite their advice on measures that could ease the States' debt repayment burden to the Centre and thereby mitigate the non-Plan capital gap. The VII Finance Commission, for instance, recommended Rs.2156 crores by way of relief on payments during 1979-84 in part through write-off and in part by rescheduling debt. The role of the Finance Commissions in helping to cover the non-Plan capital gap has come to be established through the debt relief route. Otherwise, they do not directly address themselves to the non-Plan capital gap since they can not recommend loan transfers. Indirectly, however, revenue surpluses that emerge as a result of their transfers could be applied to meet capital outgos. In effect, therefore, apart from recommendations on debt relief, the Finance Commission addresses itself primarily to the non-Plan <u>revenue</u> gap.

Assessment of the non-Plan revenue gap

We have explained the components of the non-Plan revenue gap. We can now describe the procedures followed by Finance Commissions to estimate it. The interested reader can follow the detailed procedures in the report of the VII Finance Commission (Chapter 2). For our purpose, it is sufficient to note the following principal elements of the estimation or assessment procedure. It is to be noted that the Finance Commission's assessment is more than a mere projection of the gap on the basis of data supplied by the States. It includes refinements made on the basis of the Commission's judgments, certain normative adjustments, and additional provisions on the expenditure side which reflect policy considerations.

(i) Revenues are projected to grow at rates considered appropriate by the Commission. The rates vary State-wise for different items of revenue. Similarly, the Commission applies its mind to expenditure estimates and carries out

necessary revisions. In making the projections in terms of current prices, the effects of inflation on receipts and expenditures are implicitly taken into account; however, no explicit inflation factors are applied.

(ii) Normative rates of return on investments such as on irrigation and power projects, and on road transport and other public sector undertakings are built into the estimates of revenue. To that extent, the gap is adjusted downwards.

(iii) Normative expenditure levels are provided for in respect of (a) the maintenance of capital assets already established such as roads, buildings etc and (b) for the upgradation of salaries and other emoluments in States where they are relatively low. In the case of the VII Finance Commission, adjustments were made so as to bring up emoluments to the all-States average in the case of States where they were lower. The adjustment is related to the levels in the pre-award period. The Finance Commission does not allow for increases in dearness allowances or in basic emoluments that might become necessary during its award period, or even those that might have been extended on the eve of its constitution.

(iv) The Finance Commission also makes an estimate of funds required to upgrade standards of administration in such areas as tax collection, treasury and accounts, judicial administration, general administration, police and jail administration in the case of States in which existing expenditure levels in these respects require upgradation in the Commission's analysis.[1/] Specific grants-in-aid were recommended

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1/ The Sixth Finance Commission symbolically strayed into Plan financing by including upgradation provisions not only for administrative services but also for primary education, medical and public health and welfare of scheduled castes/tribes and backward classes. The latter provisions however amounted to only Rs.530 crores or about 5.5 per cent of its total projected transfers of Rs.9609 crores. Moreover, the gap was computed inclusive of the upgradation provisions thereby further diluting the benefit to States.

by the VII Commission on this score. In other words, this element was taken care of by the VII Commission outside of the gap by way of tied grants and not as a component of it. The Commission also recommended monitoring arrangements whereby the Centre could seek to ensure that the grants were spent for the purposes intended.

Relative position of States in 1979-84

Table 5 gives the figures of the non-Plan revenue gap for the 15 major States for 1979-84 as assessed by the VII Finance Commission.[1/] The components of the gap for each State viz., tax and non-tax revenues, non-development expenditures and non-Plan development expenditures are also given on a per capita basis with the all-States' averages and the standard deviation. The States have been arranged in descending order of their per capita income.

The following features can be noted:

(i) Punjab, Haryana, Maharashtra, Gujarat and marginally, Karnataka were expected to have non-Plan revenue surpluses even prior to transfers to be made by the Finance Commission.

(ii) The average per capita tax revenue of Punjab

1/ The remaining 7 out of the 22 States in the Union are Himachal Pradesh, Jammu and Kashmir, Manipur, Meghalaya, Nagaland, Sikkim and Tripura. Together they account for about 2 per cent in the total population of the 22 States. They are also hill States with special problems and have been dealt with, along with Assam, as a special category by the Planning Commission. We have not included them in our analysis because they are not typical.

Table 5 : Non-Plan Revenue Gap and its Components 1979-84

(per capita Rs.)

State (1)	TR (2)	NTR (3)	ND(R) (4)	NPD(R) (5)	NPG(R)[1/] (6)
1. Punjab	1228.4	380.5	320.5	961.5	+286.7
2. Haryana	1100.0	264.4	316.0	643.0	+370.0
3. Maharashtra	1007.5	375.2	325.4	776.6	+256.1
4. Gujarat	847.4	197.3	253.6	684.1	+ 61.5
5. Karnataka	702.4	307.2	294.3	689.9	+ 0.4
6. W.Bengal	546.7	160.1	285.1	561.5	-193.5
7. Kerala	658.5	221.9	292.3	817.5	-249.3
8. Tamilnadu	588.9	137.3	283.4	587.6	-206.1
9. Andhra Pradesh	527.6	199.7	283.0	558.8	-133.3
10. Rajasthan	478.1	205.2	307.8	601.2	-257.1
11. Orissa	280.5	142.3	256.8	566.2	-434.8
12. Assam	293.0	206.5	240.0	501.2	-280.9
13. Madhya Pradesh	440.9	258.9	201.8	498.8	-101.6
14. Uttar Pradesh	329.4	165.2	191.0	419.7	-142.6
15. Bihar	239.5	113.3	156.9	318.2	-187.8
All States Average	549.9	208.6	252.1	565.2	
Standard Deviation	291.3	79.0	51.1	162.0	

1/ Including adjustments made by Finance Commission on account of emoluments and maintenance.

Source: Computed from State-wise tables in Appendix I. 28(i) to (xxii) (pp.113-163) of the Report of the Seventh Finance Commission 1978.

(1228.4), Haryana (1100.0), Maharashtra (1007.5), Gujarat (847.4), Karnataka (702.4), Kerala (658.5) and Tamilnadu (588.9) were above the all States average of Rs.549.9. Those below were West Bengal (546.7), Andhra Pradesh (527.6), Rajasthan (478.1), Madhya Pradesh (440.9), Uttar Pradesh (329.4), Assam (293.0), Orissa (280.5) and Bihar (239.5). The standard deviation for per capita tax revenues is the highest.

(iii) The variations in non-tax revenues are of a much smaller order. The classification of States above or below the average is the same as for tax revenues except that Gujarat and Tamilnadu are below the average, the latter significantly so, while Madhya Pradesh is above the average.

(iv) In regard to non-development expenditures, the variations in per capita expenditures among States is least. This is to be expected since outlays on basic administrative services when related to population tend to be on a relatively uniform basis. In this category, all States except Assam, Madhya Pradesh, Uttar Pradesh and Bihar are above, but not far from, the average.

(v) The average non-Plan development expenditure for all States at Rs.565.2. Here Punjab (961.5), Kerala (817.5), Maharashtra (776.6), Karnataka (689.9), Gujarat (684.1), Haryana (643.0), Rajasthan (601.2), Tamilnadu (587.6) and Orissa (566.2) are above average. Those below are West Bengal (561.5), Andhra Pradesh (558.8), Assam (501.2), Madhya Pradesh (498.8), Uttar Pradesh (419.7) and Bihar (318.2). The variation is high although less than that for tax revenue.

(vi) As an average for all States, tax revenues constitute 72.5 per cent of total revenues. On the expenditure side, non-Plan development expendituresare 69.2 per cent of all non-Plan expenditures.

Table 5 has arranged the States in the descending order of their per capita incomes. The trend in column (2) relating to per capita tax revenue will suggest a strong correlation between per capita income and per capita tax revenue. In fact, the rank correlation coefficient between rankings of States according to these two characteristics is as high as 0.957. It is to be expected that the tax realisation in a State will vary according to its SDP which, inter-alia, would be an important factor in determining its tax potential. Besides income, the tax potential is likely to be a function of several other factors such as the production structure, levels and composition of consumption expenditures, the relative size of the contribution from agriculture to SDP, income distribution, urbanisation and so on. At the same time, the extent to which the tax potential is exploited in different States, or their tax effort, will vary due to State-wise variations in the coverage, rates and collection efficiency in regard to taxes.

We can view per capita tax realisations (T) as a product of per capita income (Y) and of an X-factor (T/Y) that is related in part to structural factors, other than the income level, which affect the tax potential, and in part to the tax effort. The virtue of the T/Y ratio as a first approximation to a measure of tax effort is that it is likely to be better understood, and grounded on firmer data, than other measures that have been tried. In this sense, it is to be preferred to 'more sophisticated' alternatives fraught with academic disputation in regard to methodology and/or data.1/

1/ K.N.Reddy (1975) has attempted to estimate the tax effort of States in 1970-72 using multiple regression analysis. His choice of independent variables and the methodology leads, in his own words, to "startling results" in the sense that the rankings of States, according to these estimates is in many cases strikingly different from their T/Y ratios which Reddy himself takes to be a reasonable initial informant of tax effort. R.J.Chelliah and Narain Sinha (1982) have used the representative tax system approach to estimate tax effort in 1973-76. The rankings that result have a much closer alignment with T/Y ratios. Their paper also has a discussion of the relative limitations of the two methods.

Table 6 : T/Y ratios of States, 1978-79

State	Per Capita Income (Rs) [1]	Annual per capita tax revenue (Rs) [2]	T/Y (per cent)	Poverty proportion (per cent)
(1)	(2)	(3)	(4) =(3) /(2)	(5)
1. Punjab	1586	245.7	15.49	21.62
2. Haryana	1399	220.0	15.73	32.24
3. Maharashtra	1349	201.5	14.94	43.99
4. Gujarat	1134	169.5	14.95	44.88
5. Karnataka	1045	140.5	13.44	49.44
6. W.Bengal	1033	109.3	10.59	62.28
7. Kerala	948	131.7	13.89	62.25
8. Tamilnadu	942	117.8	12.50	60.71
9. Andhra Pradesh	928	105.5	11.37	47.85
10. Rajasthan	853	95.6	11.21	43.50
11. Orissa	793	56.1	7.07	67.50
12. Assam	791	58.6	7.41	32.95
13. Madhya Pradesh	776	88.2	11.36	57.50
14. Uttar Pradesh	715	65.9	9.21	50.38
15. Bihar	645	47.9	7.43	64.06
All States Average	930	110.0	11.83	

1/ Average for 1973-74 to 1975-76 as furnished by the VII Finance Commission.

2/ These relate to 1979-84 but at rates prevailing in 1978-79 as worked out by the VII Finance Commission.

Table 6 gives the T/Y ratios for the 15 States. The T/Y ratios (in percentages) for the richest States viz., Punjab (15.5), Haryana (15.7), Maharashtra (14.9) and Gujarat (15.0) are the highest while those for the poorest viz., Orissa (7.1), Assam (7.4), Uttar Pradesh (9.2) and Bihar (7.4) are the lowest. Madhya Pradesh is an exception in the latter group with a relatively higher ratio (11.4). Among the middle-income States, Kerala has the highest ratio (13.9) and W.Bengal the lowest (10.6).

It may interesting to examine to what extent the poverty ratio (i.e., the proportion of the population below the poverty line) may be an element in influencing the tax level or the X-factor. Table 6 also gives the poverty ratio for the 15 States as estimated by the VII Finance Commission. The rank correlation coefficient between per capita tax revenue (high to low) and the poverty ratio (low to high) is only 0.561 and quite weak. There is no systematic relationship either between T/Y and the poverty ratio. Haryana and Assam, for instance, have about the same poverty ratio but the T/Y ratio for the former is more than twice that of the latter. Kerala, Tamil Nadu and Madhya Pradesh are examples of States with relatively high poverty ratios but which also record fairly high T/Y figures. Prima facie, therefore, the poverty ratio does not seem to have a deterrent relationship on the tax potential and/or the tax effort which together determine the level of tax realisation.

On the expenditure side, relatively high levels in the revenue account are in large part a function of the numbers of employees and of salary levels. The VII Finance Commission recommended provisions for upgrading the emoluments of employees for each State so as to bring them up to the all-States' average. No provision was made for Gujarat and Kerala because emoluments in these two States were higher than the all-States' average. Table 7 gives the upgradation provisions per employee for the 15 States. It also gives the ratio of employees (government, local bodies, and aided institutions)

Table 7 : Factors influencing wage expenditures

State	Upgradation provision per employee (Rs.) 1/	No. of employees per 1000 population 2/
1. Punjab	871	19.1
2. Haryana	907	16.7
3. Maharashtra	452	14.9
4. Gujarat	-	15.8
5. Karnataka	570	13.5
6. W.Bengal	1858	16.3
7. Kerala	-	20.1
8. Tamilnadu	2094	18.0
9. Andhra Pradesh	150	13.4
10. Rajasthan	781	14.0
11. Orissa	834	15.5
12. Assam	1517	13.0
13. Madhya Pradesh	2745	14.7
14. Uttar Pradesh	605	13.7
15. Bihar	5157	9.7
All States Average		14.6

1/ For the period 1979-84 as provided by the VII Finance Commission.

2/ As in 1978-79 and includes employees of government, local bodies and aided institutions (vide Appendix I.27 to the Report of the VII Finance Commission p.112). Population figures used relate to 1971.

per 1000 of population in these States. In Kerala, both numbers and salary levels are high and this mainly explains its high expenditure levels. Both numbers and levels are lowest in Bihar; in Tamilnadu and West Bengal, numbers are high but levels are low; in Andhra Pradesh, the level is high and numbers are somewhat below the average. Numbers in Assam are about the same as in Andhra Pradesh but levels are much lower.1/

Tables 5, 6 and 7 enable us to obtain some idea of the factors responsible for the formation of surpluses and deficits in 1979-84. The broad pattern that emerges is the following. Punjab, Haryana, Maharashtra and Gujarat are the economically as well as the financially stronger States. They have the highest per capita incomes. Their high levels of revenue receipts-tax and non-tax - not only support relatively high expenditure levels - non-development and non-Plan development - but also generate surpluses for the Plan without having to depend on Finance Commission transfers. At the other end of the spectrum, Orissa, Assam, Uttar Pradesh and Bihar are both economically and financially weak. They have the lowest per capita incomes. Their expenditure levels are relatively low (except in the case of Orissa); even so, they have substantial deficits because of very low revenue receipts. The deficit (per capita) is the highest among all States for Orissa because of a combination of very low revenues and relatively high expenditures. Among the poorest States, Madhya Pradesh stands out as an exception. With relatively high revenues and relatively low expenditures, its deficit level is low, in fact the lowest among all deficit States.

1/ These figures are meant purely to bring out the comparative position of States. Neither a high ratio of employees to population nor a relatively high salary level necessarily implies wasteful expenditure. They can also mean a more intensive coverage in administrative and welfare services and fair wage policies.

The middle income States - Karnataka, West Bengal, Kerala, Tamilnadu, Andhra Pradesh and Rajasthan - exhibit varying relationships between revenues and expenditures. In terms of per capita incomes and revenue they lag behind the stronger States; but not necessarily so in terms of non-Plan development expenditures. Kerala, for instance, comes next only to Punjab in this respect and Karnataka comes ahead of Gujarat and Haryana.

The financial strength of the richer States (Punjab, Haryana, Maharashtra and Gujarat) in terms of their high per capita tax revenues and, _per contra_, the financial weakness of the poorer States (in particular, Orissa, Assam, Uttar Pradesh and Bihar) with their low per capita tax revenues would seem to reflect in each case their relative levels of per capita income in the first place. However, other factors related to economic structure, and the relative tax effort are also germane. In these respects also, the poorer States compare unfavourably as indicated by their low T/Y ratios. Non-development expenditures on a per capita basis do not show much variation inter-se among the States but there is wide variation in respect of per capita non-Plan development expenditures. This reflects relative levels of development attained so far in sectors such as education, health and other welfare and developmental services of which, the outgo on establishment costs which depend on the numbers of employees and of their levels of emoluments, is an important element.

Transfer criteria

With this background, we can examine the criteria that Finance Commissions have evolved for the distribution among States of transfers from the two taxes and for supplementing such tax-sharing, wherever necessary, with grants-in-aid under Article 275. As a preliminary point, it should be noticed that the assessed non-Plan revenue gaps of the States could themselves provide the basis for

transfers, if all that the Finance Commission was concerned with was to meet these gaps. The horizontal shares of the States would then be equal to their gaps and the vertical transfer quantum would be the sum of the gaps. The surplus States in this case would not obtain any transfers and each of the deficit States, besides getting its deficit wiped out, will receive no further benefit.

Regardless of the possible pros and cons of such a procedure, Finance Commissions have viewed the process of horizontal transfers as entailing the evolution of principles, or criteria of transfer rather than of determining the amounts of transfer, leaving the amounts to result from the application of the principles. Such criteria have been sought in one or other of three categories: (a) entitlements based on the principle of tax origination i.e., the share in tax revenues that could be expected to accrue to a State if it had been collected within its borders (b) population and (c) specific criteria of a redistributive nature. It will be clear that criterion (a) would amount to viewing the sharable taxes accruing to the Centre as taxes initially 'ceded' or 'rented' or 'contributed' by the States and which, to the extent reassigned, should logically go back to whence they arose. This principle, while having a certain juridical appeal to it, will obviously benefit the better developed States with a stronger income and production base, and will be counter-redistributive. Criterion (b) viz., population is a well recognised "broad measure" of need in the sense that it supplies an aggregation of needs at the per capita level which can be taken to be the same in all States. However, under this criteria, all States will benefit alike in per capita terms, population per capita being unity everywhere. The additional needs of States which are 'backward' in one respect or another will not be met by a simple distributive criterion such as population.[1]

1/ Equal per capita transfers can however be progressive in relation to expenditures actually being incurred, since the poorer States tend to have lower-then-average per capita expenditure levels in their non-Plan account.

For this reason, successive Finance Commissions have tried to develop redistributive criteria designed to favour 'more needy' States. The approach towards such criteria has mainly been to use the per capita income (in reverse) and/or the poverty ratio and/or some aggregation of indicators such as school enrolment, hospital beds per population, urbanisation etc which are related to backwardness or to already established needs.

Finance Commissions have in successive awards used all three types of criteria in varying combinations. They have also made a distinction between criteria applied to income tax sharing and those applied to the sharing of excise taxes. They have interpreted the "spirit" of Article 270 to mean that income taxes should be so shared that, as far as possible, all States would get uniform benefits. This view has entailed very substantial weightage being given to population. Article 272 has however been interpreted as providing more flexibility; and redistributive criteria have been used for excise sharing to some extent, with population once again playing a major role.[1/]

Table 8 gives the distribution criteria adopted by the Finance Commissions from the first to the seventh in regard

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1/ The propriety of using different criteria for income taxes and for excise has been justified, by the legal expertise on the Commissions, on the ground that income taxes "have to be" shared and, as such, each State must be provided an entitlement to it while excise duties 'may be' shared and this discretionary provision permits a more redistributive approach in respect of its transfer. There is no basis for this distinction in economic logic and Raj Krishna (1978) has in addition questioned its legal credibility.

to income taxes. All Commissions have confined their criteria to population and contribution (or collection).[1/] The respective ratios have varied between 80:20 (I, III and IV Commissions) and 90:10 (II, V, VI and VII). Tradition seems to have, by now, got itself fixed in the 90:10 ratio as far as Article 270 sharing is concerned.

Table 8 : Distribution criteria for Income Taxes

(percentages of net proceeds)

Commission	Population	Contribution
I	80	20
II	90	10
III	80	20
IV	80	20
V	90	10
VI	90	10
VII	90	10

1/ This tradition dates back from the Otto Niemeyer award following the Government of India Act of 1935. The report of the First Finance Commission (1952-57) contains a survey of Centre-Provincial financial relations in the pre-Independence period.

Table 9 gives the distribution criteria adopted by successive Finance Commissions for basic duties of Union excise. From the first to the Sixth Commissions, population has been the major deciding factor and has been used to determine 75 per cent or more of sharing from excise revenues. In regard to the balance, the III, IV and V Commissions have experimented with criteria linked to diverse specific characteristics of underdevelopment. The VI Commission reviewed a laundry list of 22 'more important' indicators of backwardness suggested by various States and concluded that in proposing indicators "each State was understandably anxious to put forward such indicators as would reflect its own interests more fully". It rejected the whole approach of using such indicators on three grounds: (a) with a high degree of correlation among the several indicators, if all or a sub-set of them were taken into account the effect will be compounded (b) the use of indicators related to backwardness in social services (e.g. school enrolment, hospital bed strength) will prejudice States like Kerala which despite a poor resource base had achieved relatively high levels of attainment in these sectors and (c) the assignment of weightage to the different indicators was "an intractable issue".1/

The VII Commission also avoided resort to specific indicators. It gave equal importance to four factors in excise sharing : (a) population (b) the inverse of the per capita State Domestic Product (c) the percentage of the

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1/ The same arguments will apply to academic proposals for basing transfers *inter-alia* on 'integrated indices of backwardness'. Examples will be found in D.M.Nanjundappa (1974), S.Venu (1978) and Hemalata Rao (1981).

Table 9 : Distribution criteria for excise duties

I Commission	:	100 per cent on population
II Commission	:	90 per cent population. 10 per cent reserved for adjustment in favour of particular States who would be otherwise left in a less advantageous position.
III Commission	:	Population major factor. The Commission also took into account "other factors like the relative financial weakness of the State, disparity in the levels of development, percentage of scheduled castes and tribes and backward classes population etc." but did not specify the exact formula.
IV Commission	:	80 per cent population. 20 per cent on the basis of (i) per capita gross value of agricultural production (ii) per capita value added by manufacture (iii) percentage of workers (as defined in the Census) to the total population (iv) percentage of enrolment in classes I to V to the population in age group 6-11 (v) population per hospital bed (vi) percentage of rural population to total population (vii) percentage of population of scheduled castes and tribes to total population. The Commission did not indicate the exact manner in which these factors were taken into account.
V Commission	:	80 per cent population. Out of the remaining 20 per cent, 2/3rds to those States whose per capita income is below the average per capita income of all States in proportion to the shortfall from the average. 1/3rd according to an integrated index of backwardness based on (i) scheduled

tribes population (ii) number of factory workers per lakh population (iii) net irrigated area per cultivator (iv) length of railways and surfaced roads per 100 square kilometres (v) shortfall in number of school-going children as compared to those of school-going age and (iv) number of hospital beds per 1000 population. The Commission used the inverse of indicators for items (ii), (iii), (iv) and (v) above, after applying some moderation in the case of States where an indicator was less than one third or more than three times of the all-States average and combined them with equal weightage to each along with the remaining indicators.

VI Commission : 75 per cent population. 25 per cent on the basis of the distance of the State's per capita income from that of the State with the highest per capita income multiplied by the State's population.

VII Commission : 25 per cent population. 25 per cent on the basis of the inverse of the per capita State Domestic Product. 25 per cent related to the percentage of the poor in the State. 25 per cent on the basis of the revenue equalisation formula developed by the Commission.

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poor in each State and (d) a formula it worked out for 'revenue equalisation'. This formula will be found in Annexure V. The revenue equalisation formula aims at compensating the poorer States in respect of poverty (i.e. per capita SDP level) as a factor that affects per capita revenue and in relation to an average tax effort arrived at through regression. Both tax and non-tax revenue are brought within the scope of "equalisation". Pre-award levels of revenue rather than revenues anticipated in the award period are used in the calculation.1/ Both the reduction in the weight to population and the inclusion, for the first time, of a criterion based on revenue were significant changes introduced by the VII Commission.2/

The vertical component

In regard to the percentages of tax-sharing as between the Centre and the States, or the vertical transfer component, successive Finance Commissions have sought to increase the proportions in favour of the States as Table 10 will show. In income taxes, the proportion has increased from 55 per cent (I Commission) to 85 per cent (VII Commission). In excise duties, the coverage of sharable items has progressively increased so as to cover all commodities by the fourth Commission. The percentage of sharing which remained at 20 per cent of the wider base in the IV, V, and VI Commissions was doubled to 40 per cent in the VII Commission.

1/ Unfortunately, the Commission did not publish the detailed workings of this formula in its report.

2/ Prof.Raj Krishna, as a member of this Commission, was of the view that the 4-factor formula was not sufficiently redistributive and proposed, in a dissenting minute, an alternative formula of population x poverty ratio x inverse of per capita income as better calculated to achieve a more equitable transfer in favour of the weaker states. He was also of the view that this formula should be applied to the sharing of income taxes as well.

Table 10 : Shares of taxes transferred

Commission	Income taxes per cent	Excise duties Coverage	Excise duties per cent
I	55	Tobacco, matches and vegetable products	40
II	60	Above plus sugar, coffee, tea, paper and vegetable non-essential oils	25
III	66.67	All commodities yielding Rs.50 lakhs per year except motor spirit	20
IV	75	All items[1/]	20
V	75	All items	20
VI	80	All items	20
VII	85	All items	40

1/ There has been some difference in the treatment of regulatory duties, and special excises from award to award in the IV to VII Commissions. Earmarked cesses are excluded.

The vertical transfer takes place not only through tax-sharing but also through grants made under Article 275. The relative proportions of these two viz., tax-sharing and grants has certain implications. A higher proportion of shared taxes will enable the States to benefit from the buoyancy in the taxes shared during the award period while grants are limited by absolute amounts. On the other hand, grants, unlike shared taxes, can be more specifically directed towards assessed needs and, therefore, can be better tuned to redistributive criteria. Grants can also be made conditional on the States incurring expected levels of expenditures on specified purposes. In the first four Commissions, Article 275 grants were in the range of 24 to 28 per cent of total transfers. The V Commission reduced the proportion to 14 per cent and the VI Commission increased it to 26 per cent. The VII Commission, as Table 1 will show, brought it down to an all-time low of about 8 per cent. A consequence of its heavy reliance on tax-sharing for effecting vertical transfers was that fairly large surpluses resulted for the higher-income States.[1/]

It is interesting to note that if transfers made by the Planning Commission are also taken into account, a sizable proportion of the two taxes envisaged in the Constitution for tax-sharing purposes is already being made over to the States. In 1982-83, income tax transfers to the States were Rs.1142 crores or 85 per cent of net proceeds. In basic excise duties, Rs.3055 crores amounting to 40 per cent were transferred. Plan grants (including those for central and centrally sponsored Plan schemes) amounted to Rs.2459 crores which as a proportion of net proceeds of basic excise revenue in 1982-83 was 33.4 per

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1/ This has been brought out in Raj Krishna (1978).

cent. Thus of the two main tax sources envisaged in the Constitution, the bulk - 85 per cent in income taxes and the equivalent of 73.4 per cent in excise duties - are being shared with the States. To put the point differently, the Plan transfers (under Article 282) have helped to retain more potential for increasing tax-sharing in the future under Articles 270 and 272, particularly the latter, States have traditionally argued that Corporation taxes should also be subject to Article 270 as was the case prior to 1959. But, obviously, it is not the size of the sharable pool but the extent of sharing, in one way or another, that matters.

Impact of criteria used by VII Commission (1979-84 and VI Plan (1980-85)

We shall now examine the effects of the transfer criteria used by the VII Finance Commission (1979-84) and of those used by the Planning Commission for the Sixth Plan period (1980-85). Table 11 brings out the effect of the VII Commission's scheme of transfers for income taxes, excise duties and the total of both with reference to the egalitarian population criterion so that the direction and extent of deviations from such a line of equality could be appreciated. It will be seen that, the income-tax transfers have been counter-redistributive due to the weightage given to contribution. The per capita transfers to Punjab, Maharashtra and Gujarat have been higher than their population entitlement; such is also the case for Tamilnadu; it is about the same as per population for Karnataka and Kerala; for the other 9 States it is less than what the population criterion would have fetched them. Excise transfers have redistributed away from the stronger States viz., Punjab, Haryana, Maharashtra and Gujarat but also from Karnataka, W.Bengal and Andhra Pradesh. They have benefited the others vis-a-vis the population criterion. However, both minuses and pluses follow an erratic pattern inter se among the States involved. Taking the two together, there is an equally incoherent pattern as the last column of Table 11 will bring out.

Table 11 : Effects of transfer criteria in the VII Commission

State	Per capita income-tax transfers	Deviation from per capita level of Rs.88.7	Per capita Excise transfers	Deviation from per capita level of Rs.209.8	Total per capita transfers	Total deviation from per capita level of Rs.298.5
1. Punjab	95.5	+ 6.8	102.6	-107.2	198.1	-100.4
2. Haryana	87.2	- 1.5	133.9	- 75.9	221.1	- 77.4
3. Maharashtra	104.1	+15.4	149.3	- 60.5	253.4	- 45.1
4. Gujarat	106.9	+18.2	106.9	-102.9	213.8	- 84.7
5. Karnataka	89.0	+ 0.3	189.4	- 20.4	278.4	- 20.1
6. W.Bengal	86.7	- 2.0	205.7	- 4.1	292.4	- 6.1
7. Kerala	88.8	+ 0.1	215.2	+ 5.4	304.0	+ 5.5
8. Tamilnadu	93.6	+ 4.9	210.4	+ 0.6	304.0	+ 5.5
9. Andhra Pradesh	88.3	- 0.4	200.9	- 8.9	289.2	- 9.3
10. Rajasthan	81.0	- 7.7	211.5	+ 1.7	292.5	- 6.0
11. Orissa	81.8	- 6.9	242.5	+ 32.7	324.3	+ 25.8
12. Assam	82.7	- 6.0	216.8	+ 7.0	299.5	+ 1.0
13. Madhya Pradesh	84.6	- 4.1	237.6	+ 27.8	322.2	+ 23.7
14. Uttar Pradesh	83.7	- 5.0	235.0	+ 25.2	318.7	+ 20.2
15. Bihar	81.0	- 7.7	262.1	+ 52.3	343.1	+ 44.6
Average	88.7		209.8		298.5	

We can now see the kind of criteria that the Planning Commission has employed for the Sixth Plan (1980-85). The formula adopted is described in paragraphs 5.55 to 5.57 (page 68) of Chapter 5 to the Plan document. Of a total projected sum of Rs.15,350 as Central Plan assistance for 1980-85, Rs.2805 crores was reserved for hill areas (Rs.560 crores), tribal areas (Rs.470 crores), the North-eastern Council (Rs.325 crores) and for special assistance to States implementing externally-aided (mainly World Bank) projects (Rs.1450 crores). Secondly, a sum of Rs.3245 crores was kept apart for 8 special category States viz., Assam, Himachal Pradesh, Jammu and Kashmir, Manipur, Meghalaya, Nagaland, Sikkim and Tripura. The balance of Rs.9300 crores was to be distributed among the other 14 States to the extent of Rs.7700 crores under the 'modified Gadgil formula' and to the extent of Rs.1600 under the 'IATP formula' details of which are not furnished. The modified Gadgil formula adopted by the National Development Council in August 1980 was 60 per cent according to population, 20 per cent to States having per capita incomes below the national average, 10 per cent on the basis of per capita tax effort and 10 per cent for special problems.

Leaving out Assam, which has been treated as a special category State in the Planning Commission's classification, we can study the effect of these formulae on the other 14 States. Table 12 gives the per capita transfers under different sources in respect of Rs.1450 crores for externally aided projects and Rs.9300 crores otherwise i.e., for the total of Rs.10,750 crores. It will show that (a) the tax effort criterion has, as might be expected, helped the stronger States with high benefits for Punjab, Haryana and Gujarat while Kerala has also well qualified. (b) the cut-off criterion of average per capita income to disqualify States falling above it has resulted in nil transfers not only to the stronger States but also to all the middle

Table 12 : Per capita Plan transfers projected for 1980-85

(Rs.)

State	Population	Tax Effort	Per capita income	Special problems	IATP	Externally aided projects	Total
1. Punjab	89.8	51.1	--	13.6	17.2	49.2	220.9
2. Haryana	89.8	65.6	--	12.0	19.7	47.4	234.5
3. Maharashtra	89.8	13.7	--	--	20.3	49.9	173.7
4. Gujarat	89.8	24.9	--	6.4	24.2	79.3	224.6
5. Karnataka	89.8	20.4	--	5.8	26.3	41.8	184.1
6. W.Bengal	89.8	10.7	--	4.5	26.6	21.9	153.5
7. Kerala	89.8	32.2	--	27.2	29.0	23.5	201.7
8. Tamilnadu	89.8	16.1	--	12.1	29.1	14.2	161.3
9. Andhra Pradesh	89.8	13.4	42.9	9.7	29.6	22.8	208.2
10. Rajasthan	89.8	18.3	50.0	29.8	32.1	22.9	242.9
11. Orissa	89.8	13.9	53.5	75.8	34.7	33.3	301.0
12. Madhya Pradesh	89.8	11.0	55.8	14.6	35.3	36.5	243.0
13. Uttar Pradesh	89.8	5.0	58.3	15.3	38.4	11.5	218.3
14. Bihar	89.8	5.4	63.7	16.3	42.5	5.8	223.5
Average	89.8	15.0	29.9	15.0	31.1	27.7	208.5

Source: Derived from Planning Commission data.

States except Andhra Pradesh and Rajasthan. (c) the special problems criterion is discretionary and defies analysis (d) the IATP criterion has been broadly redistributive and (e) the allocation for externally aided projects has tended to favour the stronger States with a higher 'absorptive capacity' for such projects as evidenced by the high transfers to Gujarat, Maharashtra, Punjab and Haryana. In the overall, the pattern that emerges is distinctly less redistributive than that for shared taxes in the VII Commission's scheme (compare Tables 11 and 12). With reference to the average projected per capita transfer of Rs.208.5 during 1980-85 for all 14 States, those above the average are Orissa (301.0), Madhya Pradesh (243.0), Rajasthan (242.9), Bihar (223.5), and Uttar Pradesh (218.3), but also three strong States viz., Haryana (234.5), Gujarat (224.6) and Punjab (220.9). All the middle States except Rajasthan, and only Maharashtra among the stronger States, fall below the average.[1/]

The critique

One thus misses a settled rationality in the transfer criteria developed by successive Finance Commissions. It is not logic but tradition that has led to the adoption of different criteria for the sharing of income taxes vis-a-vis excise duties. In income taxes, the weightage for contribution in combination with the heavy reliance on the population criterion has introduced regressive effects. Per contra, the concern has been to promote somewhat of a redistributive impact in excise sharing. The combined effect of these two

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1/ We have confined our analysis to the VII Commission and the VI Plan. For other periods, see I.S.Gulati and K.K.George (1978) for the whole period upto the V Plan, the National Institute of Public Finance and Policy (1978) in respect of the Annual Plan and IV Plan periods, and A.Bagchi (1977) in respect of the VI Finance Commission.

sets of criteria, although redistributive in a broad sense, has failed to result in any rational pattern of transfers. Despite seven Finance Commissions, no stable formula for the sharing of excise revenues, which now constitute over 70 per cent of tax sharing, has come to be evolved. In sum, a quinquennial "gamble" has persisted as Justice Rajamannar pointed out in a minute appended by him to the Report of the IV Finance Commission:

> "As regards distribution inter se among the several States... there has been a great divergence in the suggestions put forward by the States before the Finance Commissions. Population, contribution, collection, relative financial weakness, social and economic backwardness, per capita income are some of the different criteria urged by one or other of the States. In respect of such an important matter as the determination of the resources which will be available to each State as a result of a scheme of devolution, there should not be a gamble on the personal views of five persons, or a majority of them".1/

There is a further dimension of inconsistency when the Planning Commission's transfer criteria are viewed in relation to the Finance Commission's criteria. The Planning Commission by relying on population to an extent of 60 per cent of its transfers has blunted the redistributive effect. Its use of the tax effort criterion for 10 per cent and its provision of supplemental funds for externally-aided projects to the tune of an additional 10 per cent have tended to favour the stronger States. The tax effort criterion is in fact, antithetical to the revenue equalisation criterion employed by the VII Finance Commission. The Planning Commission's per capita income criterion makes a sharp open-and-shut distinction between States with per capita

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1/ Report of the Finance Commission (1965), Minute by Dr.P.V.Rajamannar pp. 86-93.

incomes below the national average and those above while the per capita income criteria of the VI and VII Finance Commissions (which have themselves differed from each other) provide for a more reasonable and gradual calibration.1/ It is to be noted also that the Planning Commission reserves as much as 10 per cent of its transfers for discretionary transfers.

1/ Given margins of error and non-comparabilities in State income estimates, the Planning Commission's cut-off criterion can be seriously invidious. Andhra Pradesh with an estimated per capita income (928) that is 0.2 per cent below the average (930) has qualified for assistance. Tamilnadu, with an estimated per capita income (942) 1.3 per cent above the average, gets disqualified.

IV

Towards a conceptual basis

It is in this background that we will have to explore whether more appropriate guiding principles could be developed for the Finance Commission's scheme of transfers, and the implications that they will have for the Planning Commission. We may start by recalling the sharing and division of labour that has come about between the two bodies. Both mediate transfers from the Centre to the States. Both are interested in effecting such transfers so as to help the needier States i.e. from a redistributive point of view. While the Finance Commission deals with the whole of non-development expenditure, and the Planning Commission wholly with development expenditures, both share responsibility for financing development expenditures, the 'Plan' part of which is the concern of the Planning Commission with the 'non-Plan' part being the concern of the Finance Commission. The burden-sharing of the two Commissions also has its dynamic aspect. As development proceeds, "non-Plan" development expenditures on the continuation or maintenance of services and facilities progressively created in successive Plans increase; so does the interest burden on increasing developmental debt which is an important component of 'non-development' expenditure. Thus the Finance Commission's concerns vis-a-vis those of the Planning Commission are partly divided, partly overlapping, and *pari-passu*.

In this context, the question has sometimes been raised whether the two Commissions can not, or should not be integrated into one. In effect, this can only mean that the Finance Commission should get integrated into the Planning Commission because a quinquennial body as envisaged in the Constitution is not suited for effecting Plan transfers as

part of the Planning process and subject to annual plans and budgets. Such a subsumation of the Finance Commission in the Planning Commission could, of course, be thought of at an institutional level but there still would be a case for a quinquennial assured devolution of resources to States to meet established levels of pre-Plan expenditures and, subsequently for supplementing it with Plan-related transfers for incremental development. In a functional sense, it would seem necessary, in these circumstances, to invent a Finance Commission if it did not exist, just as it would be to invent a Planning Commission if it did not.

But it is not enough to grant a role to the Finance Commission. The lack of settled rationality in the transfer procedures followed by successive Finance Commissions, to which we have drawn attention, shows that its role needs a conceptual clarification. The first step towards such a clarification may usefully be a negative one, namely, that the Finance Commission should not seek to direct its transfers to Plan expenditures in the aggregate (as the III Commission unsuccessfully recommended), or to sectors of expenditure that are in the domain of the Plan (as the VI Commission did to a limited extent in the name of upgradation), or by reference to needs relatable to backwardness which are precisely the concern of the Plan to satisfy.[1] As the IV Commission under Justice Rajamannar wisely pointed out "... there should not be any division of responsibility in regard to any element of Plan expenditure. The Planning Commission has been specially constituted for advising the Government of India and the State Governments in this regard. It would not be appropriate for the Finance Commission to take upon itself the task of dealing with the State's new Plan expenditures."

1/ This point will also apply to the scheme put forward in I.S. Gulati (1973) pp 1733 et seq.

Proceeding from such a basis of restraint, the Finance Commission can positively address itself to upgrading the tax revenues of States in a manner that reconciles redistribution with the promotion of fiscal responsibility. Tax revenues are, as we saw, over 70 per cent of State's total revenues. It is through a systematic and rational upgrading of tax revenues that States can be enabled to meet progressively increasing expenditure burdens that the development process entails. It is to this task of improving the ability of States, that the Finance Commission is best equipped to contribute rather than to meeting their needs defined in diffuse, confused or conflicting ways in competition with the Planning Commission.

The rationale in which they can approach this task could be as follows. The per capita level of tax revenues can be seen as the product of the per capita income and the T/Y ratio or the X-factor which itself is a function of structural parameters and the tax effort. It is beyond the Finance Commission to influence the structural factors that can lead to an improvement of the tax potential of the States. Only the long-term development process can do that. As regards the tax effort, it is up to the States to improve their performance. All that the Finance Commission can, and might, do is to ensure that the poor States are not penalised because of their poverty while ensuring that no State is compensated on the other hand for an inadequacy in its tax effort.

The income adjustment procedure

In this view, the main principle to guide transfers on the part of the Finance Commission could most appropriately be based on an income adjustment component. This will be the product of (a) the T/Y ratio (b) the difference or distance between the per capita income of the State and the one with the highest per capita income (viz., Punjab

at present) which can be called the income differential and (c) the population of the State.[1] For the purposes of tax-sharing, horizontal transfers will be in proportion to the income adjustment components thus arrived at. The vertical transfer in tax-sharing can then be a multiple of the sum of the income adjustment components such that all States, except those with a specially adverse combination of low revenue and relatively high expenditure levels, get their gaps covered. For fringe States in the latter category, statutory grants under Article 275 will be inevitable. The Finance Commission can, of course, be "logical" by leaving such residual gaps uncovered but since gaps will need to be covered at one stage or another, such an attitude will be only to shift the illogic to the Planning Commission. On the other hand, it can, by sizably increasing the vertical sharing quantum, seek to cover gaps in all States through tax-sharing alone but in that case, the surpluses that will result for a number of States will be such as to be a substantial chunk of their Plan requirements; and, indirectly, the Finance Commission will be significantly encroaching into the domain that properly belongs to the Planning Commission. In practice, as we show later, it should be possible to make tax-sharing take care of most States, restricting Art 275 grants to a minimum number of deviants.

The concern that such a scheme will entirely leave out the State with the highest per capita income and will also relatively prejudice other stronger States is a legitimate one from the standpoint of broad political considerations. These States too are part of a common Union. They too, although relatively stronger, have a variety of needs that remain to be met. Traditionally, they have had a share in income taxes in proportion to their population. This long-standing customary entitlment may have to be continued.

1/ The logic of the income adjustment principle is the same as that of the VII Commission's revenue equalisation formula except that it (a) is applied to the entire transfer (b) more sharply distinguishes tax effort (c) is related only to tax revenue and (d) applies to revenues in the award period. It is thus superior in scope and methodology.

This tradition could be accommodated, if necessary, by stretching (without violating) logic as follows. Income taxes could continue to be shared according to the simple distributive criterion of population but such a share could be made uniformly available to all States towards meeting their Plan requirements with the excise transfers being entirely deployed on the income adjustment principle outlined, towards meeting non-Plan gaps.

Table 13 contains a simulation of the procedure we have suggested above for excise sharing in 1974-1979 using the figures adopted by the VII Finance Commission. Table 14 compares the volume of vertical transfers through tax-sharing and Article 275 grants to fill the gap in the VII Commission's scheme and in the present proposal. Table 15 compares the per capita transfers to each State under the VII Commission and under the suggested alternative in respect of tax sharing and Article 275 grants (general).

It will be seen from Table 14 that the total quantum of vertical transfers in the proposal at Rs.16,795.25 crores is only 5.5 per cent higher than Rs.15,919.83 crores involved in the VII Commission's transfers. But Table 15 will show that the redistributive effect is much sharper. As against a ratio of 1.95:1 (Orissa: Punjab) for the highest and lowest per capita transfers in the VII Commission's award, the corresponding ratio in the proposal will be 5.90:1. (Orissa : Punjab). If Article 275 grants are excluded, the ratios are 1.73:1 (Bihar : Punjab) in the VII Commission and 4.22:1 (Kerala : Punjab) in our proposal.

It is important to note that the income adjustment principle compensates for income differentials at the levels of T/Y for each State. At the same level of income, a State with a higher tax effort, which is a component of T/Y, will benefit more. The principle therefore provides

Table 13 : Suggested transfers from excise based on income adjustment principle for 1979-84

State	T/Y	Income differential[1] (Rs.)	Population 1971 (crores)	Income adjustment component (Rs. crores)	Transfer[2] (Rs. crores)
(1)	(2)	(3)	(4)	(5) =(2) x(3)x(4)	(6) =(5) x3.2.
1. Punjab	0.15	-	1.36	--	--
2. Haryana	0.16	187	1.00	29.9	95.7
3. Maharashtra	0.15	237	5.04	179.2	573.4
4. Gujarat	0.15	452	2.67	181.0	579.2
5. Karnataka	0.13	541	2.93	206.1	659.5
6. W.Bengal	0.11	553	4.43	269.5	862.4
7. Kerala	0.14	638	2.13	190.3	609.0
8. Tamilnadu	0.13	644	4.12	344.9	1103.7
9. Andhra Pradesh	0.11	658	4.35	314.9	1007.7
10. Rajasthan	0.11	733	2.58	208.0	665.6
11. Orissa	0.07	793	2.19	121.6	389.1
12. Assam	0.07	795	1.46	81.2	259.8
13. Madhya Pradesh	0.11	810	4.16	370.7	1186.2
14. Uttar Pradesh	0.09	871	8.83	692.2	2215.0
15. Bihar	0.07	941	5.63	370.8	1186.6
					11392.9

1/ With reference to Punjab's per capita income of Rs.1586.

2/ Transfers are 3.2 times the income adjustment component so as to cover gaps in 13 out of 15 States leaving out the two fringe States of Orissa and Assam which will need statutory grants.

Table 14 : Comparison of volume of transfers - VII Finance Commission and as proposed

(Rs. crores)

Source	VII Finance Commission	Our proposal
Income-taxes	4688.95	4688.95
Excise	11093.96	11392.90
Art 275 grants (general)[1/]		
Assam		150.30
Orissa	136.92	563.10
	15919.83	16795.25

1/ Excludes specific purpose upgradation grants.

Table 15 : Per capita transfers - VII Finance Commission and as proposed[1/]

State (1)	VII Commission (2)	As proposed (3)
1. Punjab	198.1	88.7
2. Haryana	221.1	184.4
3. Maharashtra	253.4	202.6
4. Gujarat	213.8	305.7
5. Karnataka	278.4	313.7
6. W.Bengal	292.4	282.9
7. Kerala	304.0	374.5
8. Tamilnadu	304.0	356.5
9. Andhra Pradesh	289.2	320.4
10. Rajasthan	292.5	346.6
11. Orissa	386.8(324.3)	523.4(266.3)
12. Assam	299.5	369.8(266.9)
13. Madhya Pradesh	322.2	373.8
14. Uttar Pradesh	318.7	339.6
15. Bihar	343.1	299.6

1/ Transfers from income taxes, basic excise and Article 275 general grants (i.e. not including upgradation grants). Figures in brackets against Orissa and Assam indicate tax sharing element excluding Article 275 grants.

an incentive to States to improve their tax effort in the longer run. However, in any transfer procedure that is required to meet existential gaps, regardless of casual factors that have contributed to them, there will be no leverage or pressure to improve tax effort. This leverage can be exercised, in the division of responsibility that has emerged, only by the Planning Commission since the additional resource mobilisation efforts of States are decided as part of Plan financing and are a contribution to it. The Planning Commission in determining its transfers should upgrade the tax effort of the lagging States. In turn, it may also match every rupee of additional per capita tax with an income adjustment supplement on the same principle as the Finance Commission. This supplement will be the ratio of the income differential to the States' per capita income. Added on to the State's own tax effort, it will perform the same function as the Finance Commission's income adjustment component. The supplements based on the per capita income figures we have used for various States are provided in Table 16.

Apart from levels of surpluses that might vary from State to State for other reasons,[1] the initial resources for financing the Plan revenue component will then consist of (a) the uniform per capita transfer from the Finance Commission from income tax-sharing and (b) additional resources to be secured from the States, supplemented by the Planning Commission's income adjustment transfers. On this basis, further need-based adjustments to the extent necessary can be worked out by the Planning Commission.

1/ These include surpluses ex ante to the Finance Commission transfers; those that might result from tax-rental transfers such as on account of additional excise duties in lieu of sales taxes; and the over-run of Finance Commission's transfers from excise vis-a-vis gaps.

Table 16 : Income adjustment supplements to be used by the Planning Commission

State	Income adjustment supplement per rupee of additional tax (Rs.)
1. Punjab	--
2. Haryana	0.13
3. Maharashtra	0.18
4. Gujarat	0.40
5. Karnataka	0.52
6. W.Bengal	0.54
7. Kerala	0.67
8. Tamilnadu	0.68
9. Andhra Pradesh	0.71
10. Rajasthan	0.86
11. Orissa	1.00
12. Assam	1.01
13. Madhya Pradesh	1.04
14. Uttar Pradesh	1.22
15. Bihar	1.46

With a coordinated upgradation of States' tax revenues in respect of both incomes and effort on the lines outlined, larger internal resources can be expected to be available in the award period(s) of subsequent Finance Commission(s), progressively narrowing inter-State per-capita differentials in the non-Plan revenue gap. States receiving Article 275 grants in one award period (e.g. Orissa and Assam in our example) should in particular be induced to improve their tax effort so that within one or two subsequent award periods their non-Plan revenue gaps could also be taken care of under the general tax sharing framework without need for supplemental special assistance under Article 275. Both the Finance Commission and the Planning Commission would provide incentives to the poorer States to improve their tax effort, with the Planning Commission exercising leverage in this regard. At the same time, both will compensate in their transfer procedures for income inequality, with the Finance Commission making the main contribution in this regard. Thereby their transfers can be coordinated in order to promote a medium-term adjustment process for financial viability in the States based on rational and equitable principles. In this way, both the Planning Commission and the Finance Commissions can work in tandem i.e., "like horses in harness, one behind another".

V

Certain unresolved issues.

We have concentrated so far on the transfer criteria employed by the Finance Commissions and the Planning Commission because they are central to the role of these bodies in mediating the sharing of financial resources among the constituents of the federation. We shall devote this final section to a brief statement of a set of wider issues in federal financial relations which need to be taken into account in evaluating the role and the potential of these two sets of Commissions. These issues have remained largely unresolved.

1. The Finance Commission is required under its guidelines "to have regard to the scope for better fiscal management and economy in expenditure consistent with efficiency". It seeks to do this mainly by postulating normative rates of return from public investments and by assuming levels of reasonable effort in tax collection and in loan recoveries on the part of the States. The VII Finance Commission broke new ground in making a brief assessment of the Centre's resource position and applied some norms to the Centre as well. However, the time and expertise available to the Finance Commission do not permit any detailed review of economy and efficiency in financial management in the States and much less in the Centre. The importance of the inter-related pursuit of economy (minimising costs for a given return) and of efficiency (maximising returns for a given cost) in public expenditures can not be over-emphasised, particularly in a poor developing economy such as ours. The Janata Government (1977-80) came up with the initiative of setting up an Expenditure Commission for Central expenditures. One of the first acts of the present government was to wind up this body. There are many factors that contribute to waste and management at both the political and bureaucratic

levels of government. An independent body may not be able to fully correct such factors but may be able, given the necessary authority and the expertise, to expose them in large measure. This can be a very useful contribution.

2. Tax planning at the State level in relation to an objective assessment of the tax potential is not undertaken in any systematic manner. This involves a continual review and improvement to rates, coverage and collection of taxes. In this respect, States can also learn from each other so that the 'best examples' can be progressively generalised. A body that can study and suggest improvements could make a useful contribution at the technical level.

3. The borrowings of the States are mainly used for irrigation and power projects. These do not yield adequate returns in terms of interest, after meeting maintenance and depreciation, let alone surpluses that can be used for repaying the loans based on which the investments have been undertaken. In these circumstances, the debt problem of the States has had to be taken care of by the foregoing or postponement of debt payments to the Centre as recommended by successive Finance Commissions since the VI Commission. Such accommodation only shifts the problem from the States to the Centre. The Centre is not in a position to defer or deny repayments to the public, the banking system, or external governments and agencies which are its lenders. It can make fresh borrowings to cover repayments but this will reduce net borrowings available for investment over time. The final safety value will be progressively increasing levels of deficit financing. In the longer run, given the nature of public investments by the Centre and the States -- mainly railways, roads, irrigation and power -- revenue resources, mainly in the form of taxes, will have to be mobilised for not only meeting revenue expenditures but also for amortising capital investments. In other words, Finance Commissions will, in

estimating the revenue gaps, have to provide an element for the amortisation of debt; and may not be able in the longer run, to continue with the rescheduling or reduction of debt as the main means of reducing the capital gap. In the final analysis, real resources have to be mobilised by the Centre and/or the States, mainly as taxes, to finance public investment in the major categories in which they take place.

4. Finance Commissions have tried to reduce inter-se disparities among the States in the emolument levels of their employees to some measure. However, differentials between average emoluments of State employees and those of the Centre are significant. The VII Finance Commission also noted that they had widened between 1972 and 1977 as the following table will show.

Table 17 : Average emoluments of State employees (all-States average) as a proportion of average emoluments of Central employees

(per cent)

Category	1.1.1972	1.1.1977
Upto Rs.200	86.5	78.3
Rs.201 - Rs.400	86.3	82.8
Rs.401 - Rs.700	77.6	73.8

Two issues are involved here. One, a progressive harmonisation of wage policies, Centre-States and inter-State. Second, additional financial support to States for dearness allowance increases, based on national norms, when they are extended from time to time in the award period.

These increases make a major inroad into State finances but they are not taken into account in the Finance Commission's settlement.

5. Unauthorised overdrafts on the part of States is a phenomenon that has persisted since 1950. The Fifth Commission (1969), to which the matter was referred, made a series of recommendations designed to contain the problem and to tackle it in the case of persistent default. The problem has continued; and, from time to time, its incidence has enlarged in terms of the number of States involved and the size of the overdrafts. On the latest occasion, the Centre has had to extend Rs.1743 crores to clear the closing deficit of as many as 17 States at the end of 1981-82. This is as high as about 38 per cent of the transfers made under the Finance Commission in 1981-82. Overdrafts are forced transfers in favour of certain States and to the prejudice of others; they occur for reasons within and outside the control of the States; and with or without the acquiescence of the Centre. In any event, persistent, large and wide-spread overdrafts undermine the fabric of institutionalised transfers. There is need for adequate techno-political approaches to tackle this problem.

6. A major weakness in the present system is that the quinquennial appearance and disappearance of Finance Commissions is not calculated to build 'memory' in the system. There is no systematic *ex post* evaluation of the projections made by successive Finance Commissions in terms of the direction and degree of variations and the nature of the causal factors contributing to them. As a consequence, no systematic lessons are drawn for improving techniques of projection, for dealing with financial contingencies, and generally for promoting better financial management.

An inter-State Council

In the context of all these issues, two suggestions respectively made by the IV and the VII Commissions deserve notice. The IV Commission suggested a regular consultative mechanism between the Centre and the States pointing out that "regular meetings at policy, as well as implementation, levels will.. be helpful to all concerned... in promoting clearer understanding and firmer approval of common financial policies. Once the practice of regular consultation is established it will tend to cover a growing area of common financial interest, not confined to tax-sharing, but extending to exchange of experiences which may lead to greater and greater coordination in policy and procedure..... In countries having comparable financial relationships between a Central and several State Governments the functioning of similar institutional devices of regular consultation has produced valuable results. It would appear that the time is ripe in India to make at least a beginning in this respect."

The VII Finance Commission while concluding its report felt that "it will be extremely useful to future Finance Commissions and greatly facilitate their work, if an expert non-political agency were to be established by the Central Government and were to perform such functions as the Secretariat of the Commission is expected to perform. In addition, it would be expected to play a watching and advisory role with regard to Centre-State financial relations generally. As and when a full-fledged Finance Commission is appointed, this agency could get merged into the Commission and its Secretariat ..... Whether it should be located in the Finance Ministry or in the Planning Commission, or preferably perhaps as an independent unit, is a matter of detail which can be considered later, taking into account the necessity of making it active and effective."

One can widen the horizons of both these suggestions. The 'regular consultative practices' suggested by the IV Commission can be institutionalised. The 'expert non-political agency' suggested by the VII Commission need not be just a standing secretariat for Finance Commissions located here or there waiting to be merged with Finance Commissions as and when they are set up. Article 263 of the Constitution envisages that "if at any time it appears to the President that the public interests would be served by the establishment of a Council charged with the duty of .. investigating and discussing subjects in which some or all of the States, or the Union and one or more of the States, have a common interest ... it shall be lawful for the President by order to establish such a Council, and to define the nature of the duties to be performed by it and its organisation and procedure".

An inter-State Council under this provision might be the most appropriate body to tackle the kind of techno-political issues we have outlined viz., economy and efficiency, tax planning, resource mobilisation, wage policy for public employees, overdrafts, and systematic evaluations of the work of Finance Commissions as well as that of the Planning Commission. In all these issues, the Union and, not one or more but, all of the States have, or should have, a common interest. The inter-State Council could adopt firm criteria for the Finance Commission and Plan transfers. A quinquennial Finance Commission may still be necessary to review forecasts of revenue and expenditures, assess gaps, comment on economy and tax effort, recommend the quantum of tax-sharing and the grants-in-aid under Article 275 and to deal with all other matters that may be referred to it "in the interests of sound finance". Its legal stature may gain, rather than lose, if its function thus derives from, and feeds into, a decision-making body that might give reality to the first Article of the Constitution which defines India 'as a Union of States'.

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Annexure I

THE CONSTITUTION OF INDIA - SEVENTH SCHEDULE

(Article 246)

SEPARATION OF FINANCIAL POWERS

UNION LIST

82 Taxes on income other than agricultural income.

83 Duties of customs including export duties.

84 Duties of excise on tobacco and other goods manufactured or produced in India except -

(a) alcoholic liquors for human consumption;

(b) opium, Indian hemp and other narcotic drugs and narcotics, but including medicinal and toilet preparations containing alcohol or any substance included in sub-paragraph (b) of this entry.

85 Corporation Tax.

86 Taxes on the capital value of the assets, exclusive of agricultural land of individuals and companies; taxes on the capital of companies.

87 Estate duty in respect of property other than agricultural land.

88 Duties in respect of succession to property other than agricultural land.

89. Terminal taxes on goods or passenger, carried by railways, sea or air; taxes on railway fares and freights.

90 Taxes other than stamp duties on transactions in stock exchanges and future markets.

91 Rates of stamp duty in respect of bills of exchange, cheques, promissory notes, bills of lading, letters of credit, policies of insurance, transfer of shares, debentures, proxies and receipts.

92 Taxes on the sale or purchase of newspapers and on advertisements published therein.

92.A Taxes on the sales purchase of goods other than newspapers, where such sale or purchase takes place in the course of inter-State trade or commerce.

STATE LIST

45 Land revenue, including the assessment and collection of revenue, the maintenance of land records, survey for revenue purposes and records of rights, and alienation of revenues.

46 Taxes on agricultural income.

47 Duties in respect of succession to agricultural land.

48 Estate duty in respect of agricultural land.

49 Taxes on lands and buildings.

50 Taxes on mineral rights subject to any limitations imposed by Parliament by law relating to mineral development.

51 Duties of excise on the following goods manufactured or produced in the State and countervailing duties at the same or lower rates on similar goods manufactured or produced elsewhere in India:

(a) alcoholic liquors for human consumption;

(b) opium, Indian hemp and other narcotic drugs and narcotics; but not including medicinal and toilet preparations containing alcohol or any substance included in sub-paragraph (b) of this entry.

52 Taxes on the entry of goods into a local area for consumption, use or sale therein.

53 Taxes on the consumption or sale of electricity.

54 Taxes on the sale or purchase of goods other than newspapers, subject to the provisions of entry 92-A of List I.

55 Taxes on advertisements other than advertisements published in the newspapers.

56 Taxes on goods and passengers carried by road or on inland waterways.

57 Taxes on vehicles, whether mechanically propelled or not, suitable for use on roads, including tramcars subject to the provisions of entry 35 of List III.

58. Taxes on animals and boats.

59 Tolls.

60 Taxes on professions, trades, callings and employments.

61 Capitation taxes.

62 Taxes on luxuries, including taxes on entertainments, amusements, betting and gambling.

63 Rates of stamp duty in respect of documents other than those specified in the provisions of List I with regard to rates of stamp duty.

CONCURRENT LIST

44 *Stamp duties other than duties or fees collected by means of judicial stamps, but not including rates of stamp duty.

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*Not applicable to the State of Jammu and Kashmir.

Annexure II

Provisions of the Constitution having a bearing on the work of the Finance Commission

Article 268 - Duties levied by the Union but collected and appropriated by the States

(1) Such stamp duties and such duties of excise on medicinal and toilet preparations as are mentioned in the Union List shall be levied by the Government of India but shall be collected -

(a) in the case where such duties are leviable within any Union territory, by the Government of India, and

(b) in other cases, by the States within which such duties are respectively leviable.

(2) The proceeds in any financial year of any such duty leviable within any State shall not form part of the Consolidated Fund of India, but shall be assigned to that State.

Article 269 - Taxes levied and collected by the Union but assigned to the States

(1) The following duties and taxes shall be levied and collected by the Government of India but shall be assigned to the States in the manner provided in clause (2), namely:-

(a) duties in respect of succession to property other than agricultural land;

(b) estate duty in respect of property other than agricultural land;

(c) terminal taxes on goods or passengers carried by railway, sea or air;

(d) taxes on railway fares and freights;

(e) taxes other than stamp duties on transactions in stock exchanges and futures markets;

(f) taxes on the sale or purchase of newspapers and on advertisements published therein;

(g) taxes on the sale or purchase of goods other than newspapers, where such sale or purchase takes place in the course of inter-State trade or commerce.

(2) The net proceeds in any financial year of any such duty or tax, except in so far as those proceeds represent proceeds attributable to Union territories, shall not form part of the Consolidated Fund of India, but shall be assigned to the States within which that duty or tax is leviable in that year, and shall be distributed among those States in accordance with such principles of distribution as may be formulated by Parliament by law.

(3) Parliament may by law formulate principles for determining when a sale or purchase of goods takes place in the course of inter-State trade or commerce.

Article 270 - Taxes levied and collected by the Union and distributed between the Union and the States

(1) Taxes on income other than agricultural income shall be levied and collected by the Government of India and distributed between the Union and the States in the manner provided in clause (2).

(2) Such percentage, as may be prescribed, of the net proceeds in any financial year of any such tax, except in so far as those proceeds represent proceeds attributable to Union territories or to taxes payable in respect of Union emoluments, shall not form part of the Consolidated Fund of India, but shall be assigned to the States within which that tax is leviable in that year, and shall be distributed among those States in such manner and from such time as may be prescribed.

(3) For the purposes of clause (2), in each financial year such percentage as may be prescribed of so much of the net proceeds of taxes on income as does not represent the net proceeds of taxes payable in respect of Union emoluments shall be deemed to represent proceeds attributable to Union territories.

(4) In this article -

(a) "taxes on income" does not include a corporation tax;

(b) "Prescribed" means -

(i) until a Finance Commission has been constituted, prescribed by the President by Order, and

(ii) after a Finance Commission has been constituted prescribed by the President by Order after considering the recommendations of the Finance Commission;

(c) "Union emoluments" includes all emoluments and pensions payable out of the Consolidated Fund of India in respect of which income-tax is chargeable.

<u>Article 271 - Surcharge on certain duties and taxes for purposes of the Union</u>

Notwithstanding anything in articles 269 and 270, Parliament may at any time increase any of the duties or taxes referred to in those articles by a surcharge for purposes of the Union and the whole proceeds of any such surcharge shall form part of the Consolidated Fund of India.

<u>Article 272 - Taxes which are levied and collected by the Union and may be distributed between the Union and the States</u>

Union duties of excise other than such duties of excise on medicinal and toilet preparations as are mentioned in the

Union List shall be levied and collected by the Government of India, but, if Parliament by law so provides, there shall be paid out of the Consolidated Fund of India to the States to which the law imposing the duty extends sums equivalent to the whole or any part of the net proceeds of that duty, and those sums shall be distributed among those States in accordance with such principles of distribution as may be formulated by such law.

Article 275 - Grants from the Union to certain States

(1) Such sums as Parliament may by law provide shall be charged on the Consolidated Fund of India in each year as grants-in-aid of the revenue of such States as Parliament may determine to be in need of assistance, and different sums may be fixed for different States:

Provided that there shall be paid out of the Consolidated Fund of India as grants-in-aid of the revenues of a State such capital and recurring sums as may be necessary to enable that State to meet the costs of such schemes of development as may be undertaken by the State with the approval of the Government of India for the purpose of promoting the welfare of the Scheduled Tribes in that State or raising the level of administration of the Scheduled Areas therein to that of the administration of the rest of the areas of that State:

Provided further that there shall be paid out of the Consolidated Fund of India as grants-in-aid of the revenues of the State of Assam sums, capital and recurring equivalent to -

(a) the average excess of expenditure over the revenues during the two years immediately preceding the commencement of this Constitution in respect of the administration of the tribal areas specified in Part A of the table appended to paragraph 20 of the Sixth Schedule; and

(b) the cost of such schemes of development as may be undertaken by that State with the approval of the Government of India for the purpose of raising the level of administration of the said areas to that of the administration of the rest of the areas of that State.

(2) Until provision is made by Parliament under clause (1) the powers conferred on Parliament under that clause shall be exercisable by the President by order and any order made by the President under this clause shall have effect subject to any provision so made by Parliament:

Provided that after a Finance Commission has been constituted no order shall be made under this clause by the President except after considering the recommendations of the Finance Commission.

Article 280 - Finance Commission

(1) The President shall, within two years from the commencement of this Constitution and thereafter at the expiration of every fifth year or at such earlier time as the President considers necessary, by order constitute a Finance Commission which shall consist of a Chairman and four other members to be appointed by the President.

(2) Parliament may by law determine the qualifications which shall be requisite for appointment as members of the Commission and the manner in which they shall be selected.

(3) It shall be the duty of the Commission to make recommendations to the President as to -

(a) the distribution between the Union and the States of the net proceeds of taxes which are to be, or may be, divided between them under this chapter and the allocation between the States of the respective shares of such proceeds;

(b) the principles which should govern the grants-in-aid of the revenues of the States out of the Consolidated Fund of India;

(c) any other matter referred to the Commission by the President in the interests of sound finance.

(4) The Commission shall determine their procedure and shall have such powers in the performance of their functions as Parliament may by law confer on them.

Article 281 - Recommendations of the Finance Commission

The President shall cause every recommendation made by the Finance Commission under the provisions of this Constitution together with an explanatory memorandum as to the action taken thereon to be laid before each House of Parliament.

Article 282 - Expenditure defrayable by the Union or a State out of its revenues

The Union or a State may make any grants for any public purpose, notwithstanding that the purpose is not one with respect to which Parliament or the Legislature of the State, as the case may be, may make laws.

Annexure III

The Composition of Finance Commissions

Article 280 of the Constitution limits the size of Finance Commissions to a total of five including the Chairman. The Finance Commission (Miscellaneous Provisions) Act, 1951 (Act No.33 of 1951) specifies (in clause 3) that the Chairman shall be selected from among persons who have had experience in public affairs. The four other members are to be drawn from one or other of the following categories: (a) those who are, or have been, or are qualified to be appointed as a Judge of a High Court or (b) those with special knowledge of the Finances and accounts of Government or (c) have had wide experience in financial matters and in administration or (d) have special knowledge of economics.

Out of eight Finance Commissions appointed so far, five have been chaired by political figures from the ruling party, two by judges and the other by a civil servant. All of them except the VII Commission (1979-84), appointed during the Janata government, have had one or more members with a political background. Out of 42 persons who have held office as members of the eight Finance Commissions, 9 were politicians, 8 judges, 10 economists and 15 civil servants. Besides outnumbering other categories, the civil service has throughout provided the member - secretaries to the Commission. Since the VI Commission (1974-79), a member of the Planning Commission has also served on the Finance Commission.

The following have been Chairmen of the Commissions:
I : K.C.Neogy II : K.Santhanam III : A.K.Chanda IV : P.V.Rajamannar V : Mahavir Tyagi VI : K.Brahmananda Reddy VII : J.M.Shelat and VIII : Y.B.Chavan.

Economists who have served on the Commissions are:
I : B.K.Madan II : B.N.Ganguly III : M.V.Mathur IV : Bhabatosh Datta V : D.T.Lakdawala VI : B.S.Minhas; I.S.Gulati VII : Raj Krishna; C.H.Hanumantha Rao and VIII : C.H.Hanumantha Rao.

Annexure IV

Terms of Reference for the Eighth Finance Commission

In pursuance of the provisions of article 280 of the Constitution of India and of the Finance Commission (Miscellaneous Provisions) Act, 1951 (33 of 1951), the President is pleased to constitute a Finance Commission consisting of Shri Y.B.Chavan, Member of Parliament as the Chairman and the following four other Members namely:-

1. Shri Justice Sabya Sachi Mukherjee, Judge, Calcutta High Court.
2. Dr.C.H.Hanumantha Rao, Member, Planning Commission.
3. Shri G.C.Baveja, Secretary, Ministry of Finance
4. Shri A.R.Shirali, Deputy Comptroller & Auditor General of India.

2. The Chairman and other Members of the Commission shall hold office from the date on which they respectively assume office upto the 31st day of October 1983.

3. The Chairman shall render part-time service to the Commission. Shri Justice Sabya Sachi Mukherjee and Dr.C.H. Hanumantha Rao shall render part-time service as Members of the Commission, Shri G.C.Baveja shall render part-time service upto 30th June, 1982 and full-time service thereafter. Shri A.R.Shirali shall render full-time service.

4. The Commission shall make recommendations as to the following matters:-

(a) The distribution between the Union and the States of the net proceeds of taxes which are to be, or may be, divided between them under Chapter 1 of Part XII of the Constitution and the allocation between the States of the respective shares of such proceeds;

(b) the principles which should govern the grants-in-aid of the revenues of the States out of the Consolidated Fund of India and the sums to be paid to the States which are in need of assistance by way of grants-in-aid of their revenues under article 275 of the Constitution for purposes other than those specified in the provisos of clause (1) of that article.

5. In making its recommendations, the Commission shall have regard, among other considerations, to :-

(i) the resources of the Central Government and the demands thereon on account of the expenditure on civil administration, defence and border security, debt servicing and other committed expenditure or liabilities;

(ii) the existing practice in regard to determination and distribution of Central assistance for financing State plans;

(iii) the revenue resources of those States for the five years ending with the financial year 1988-89 on the basis of the levels of taxation likely to be reached at the end of the financial year 1983-84 and the targets set for additional resource mobilisation for the Plan;

(iv) the requirements on revenue account of those States to meet the expenditure on administration and other non-Plan commitments or liabilities, keeping however in view national policies and priorities. In assessing such requirements, the Commission shall take into account:-

(a) such provision for emoluments and terminal benefits of Government employees, teachers and employees of local bodies as obtaining on a specified date as the Commission deems it proper and with reference to appropriate objective criteria rather than in terms of actual increases that may have been given effect to; and

(b) commitments in regard to interest charges on their debt, transfer of funds to local bodies and aided institutions;

(v) adequate maintenance and upkeep of capital assets and maintenance of Plan schemes completed by the end of 1983-84, the norms, if any, on the basis of which specified amounts are allowed for the maintenance of different categories of capital assets and the manner in which such maintenance expenditure could be monitored, being indicated by the Commission;

(vi) the requirements of States for upgradation of standards in non-developmental sectors and services particularly of States which are backward in general administration with a view to bringing them to the levels obtaining or likely to obtain in the more advanced States, the manner in which such expenditure could be monitored, being also indicated by the Commission;

(vii) the scope for better fiscal management and economy in expenditure consistent with efficiency; and

(viii) the need for ensuring reasonable returns on investments in irrigation and power projects, transport undertakings, industrial and commercial enterprises and the like.

6. The Commission may suggest changes, if any, to be made in the principles governing the distribution among the States of:-

(a) the net proceeds in any financial year of estate duty in respect of property other than agricultural land;

(b) the net proceeds in any financial year of the additional excise duties leviable under the Additional Duties of Excise (Goods of Special

Importance) Act, 1957, in replacement of the sales tax levied formerly by the State Governments on each of the following commodities; namely:-

(i) cotton fabrics;

(ii) woollen fabrics;

(iii) rayon or artificial silk fabrics;

(iv) sugar; and

(v) tobacco including manufactured tobacco:

Provided that the share accruing to each State shall not be less than the revenue realised from the levy of sales tax for the financial year 1956-57 in that State.

(c) the grant to be made available to the States in lieu of the tax under the repealed Railway Passenger Fares Tax Act, 1957; and

(d) the grant to be made available to the States on account of wealth tax on agricultural property.

7. In making its recommendations on the various matters aforesaid, the Commission shall adopt the population figures of 1971 in all cases where population is regarded as a factor for determination of devolution of taxes and duties and grants-in-aid.

8. The Commission may examine the scope for raising revenue from the taxes and duties mentioned in article 269 of the Constitution but not levied at present and the scope for enhancing revenue from the duties mentioned in article 268.

9. The Commission may make an assessment of the non-Plan capital gap of the States on a uniform and comparable basis for the five years ending with 1988-89. In the light of such an assessment, the Commission may undertake a general review of the States' debt position with particular reference to the Central loans advanced to them and likely to be outstanding

as at the end of 1983-84 and suggest appropriate measures to deal with the non-Plan capital gap, having regard inter-alia to the overall non-Plan gap of the States, their relative position and the purposes for which the loans have been utilised and the requirements of the Centre.

10. The Commission may review the policy and arrangements in regard to the financing of relief expenditure by the States affected by natural calamities and suggest such modifications as it considers appropriate, in the existing arrangements, having regard, among other considerations, to the need for avoidance of wasteful expenditure.

11. The Commission shall make its report by the 31st October, 1983 on each of the matters aforesaid and covering a period of five years commencing from the 1st day of April, 1984. The Commission shall indicate the basis on which it has arrived at its findings and make available the State-wise criteria adopted in making modifications, if any, in the States' forecasts of receipts and expenditure.

N.SANJIVA REDDY
PRESIDENT

Dated the 20th June 1982

Annexure V

Extract from the Report of the VII Finance Commission on the 'revenue equalisation' formula

(paragraph 39, Chapter 9, page 87)

The revenue equalisation principle we have adopted is a recognition of the fact that States which are less favourably placed in regard to their resource potential should be specially helped in order to place them in a position where they can also take steps more readily for the betterment of the people living in those States. We have computed the per capita revenue potential of each State with reference to the average per capita SDP for the triennium 1973-76. The per capita average of each State's own tax and non-tax revenue for 1975-76 and 1976-77, obtained from the Accounts, were regressed on the average per capita income, excluding the five atypical States of Manipur, Meghalaya, Nagaland, Sikkim and Tripura. We thus derived the estimated values of per capita revenue of each State. The distance of the per capita revenue thus estimated for each State from the maximum estimated per capita revenue among all the States - that of Punjab - has been multiplied by the estimated population of the States as on 1st March 1976 obtained from the Registrar General. For the atypical States their own average per capita revenue for the years 1975-76 and 1976-77 has been adopted. The percentage of the product of the distance of the per capita revenue so estimated from that of Punjab and the population for each State in the total of these products for all the States gives us the share of each State in the 25 per cent component of the divisible pool of excise. In the process described, it will be noted that if a State has been lacking in effort to raise resources compatible with its resource potential, it will not be rewarded. Nor is any State penalised which has raised resources in excess of the estimated revenue consistent with its resource potential.